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DEVELOPMENT AND STRUCTURE OF MORTGAGE LOAN GUARANTY INSURANCE IN THE UNITED STATES

JAMES GRAASKAMP

Privately financed, residential mortgage loan guaranty insurance has evolved, since 1957, from the status of an outlawed curiosity to recognition as a special class of legitimate insurance enterprise, governed by a unique and fresh sector of regulatory law. The original guaranty firm[1] controls more than $43 million in assets, has achieved a listing on the American Stock Exchange, and served as a model for an industry of at least ten firms, benefiting from total assets of $63.8 million behind insurance in force of approximately $3 billion as of January 1, 1966.[2]

In the past decade the insurance industry sought multiple-line integration of companies and contracts, struggled with the minutiae of change in the regulatory bogs, and threatened the single-line, single market company with extinction. Still, during the same period, mortgage loan guaranty insurance began to thrive by insuring only institutional lenders for loss from a single peril—mortgage default—in regard to a single property class, the owner-occupied residence of one-to-four family units. This development was achieved in cooperation with imaginative and unique regulation efforts on the part of a few state insurance commissions. In an era of rising sales cost, the guaranty firm has largely eliminated commissions of any kind, finds some marginal cost savings in superficial underwriting, and in one context, sometimes violates the principle of indemnity to achieve economy.

The mortgage loan guaranty of 1966 is a phenomenon within the insurance family

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[1] Mortgage Guaranty Insurance Company of Milwaukee, organized 1957. Data from 1965 Annual Report. MGIC coverage is available in 47 states.

NAME	SYMBOL	ORG.	HOME OFFICE	INS. IN FORCE*	TOTAL ASSETS*
Mortgage Guaranty Insurance Corp.	MGIC	1957	Milwaukee, Wis.	$2,500	$43.6
Continental Mortgage Insurance after merger w. Institutional Mortgage Insurance	CMI	1961	Madison, Wis.	218	6.2
American Mortgage Insurance	AMI	1959	Raleigh, N.C.	200	4.3
First Mortgage Insurance Corp.	FMIC	1964	Greensborough, N.C.	80	2.8
Southern Mortgage Insurance Corp.	SMIC	1964	Baton Rouge, La.	38	1.4
Excel Mortgage Insurance Co.	EMIC	1963	Bettendorf, Iowa	24	2.4
First National Indemnity Co.	FNIC	1965	Houston, Tex.	14	1.1
Liberty Mortgage Insurance Co.	LMIC	1965	Springfield, Ill.	8	.6
Guaranty Insurance Trust	GIT	1965	Columbia, S.C.	—	1.1
General Mortgage Insurance Co.	GMIC	1966	Winston Salem, N.C.	—	.4
				$3,082	$63.9

* 000,000 omitted

which deserves respectful attention for creative financial and market management and for its symbiotic relationship with government regulation. The history of the mortgage loan guaranty has been highly instructive on the relationship of insurance theory to insurance practice, but as yet the theory and practice of this specialty have been largely ignored in professional insurance literature. While the essential research question for the student of mortgage loan insurance at this time is that of measuring reserve adequacy and related issues of regulation, it is first necessary to create a more general familiarity with the present guarantor program, modus operandi, and economic relationships.

Therefore this essay will serve to report the significant economic, institutional, legal, financial, and insurance aspects[3] of the private mortgage loan guaranty. A later article will treat two pivotal questions of public policy, specifically criteria for reserve adequacy and for regulatory control of an embryonic industry. This latter discussion will utilize a reserve-accumulation, simulation model program for the computer, prepared in a project with Professor Howard Thompson,[4] as well as independent study of the national mortgage loan guaranty situation. The present article will synthesize studies done in concert with Professor Richard M. Heins,[5] while serving as consultants to the original mortgage loan guaranty firm.

The Historical Context

Modern mortgage loan insurance has been defined as the indemnification of government supervised, mortgage lending institutions for the direct and consequential losses incurred by reason of nonpayment of a first mortgage loan, loans generally restricted to resident-owners of single family, duplex, or up to four-unit rental buildings.[6] The coverage is classified as credit insurance, subject to the general requirements of a casualty insurance company, as well as the most severe minimum capital and reserve requirements of any recognized line of insurance. It was not ever thus, and each restraint represents experience acquired at great cost.

Geneology

The paternal ancestor of mortgage loan insurance, specifically the extinct mortgage investment guaranty, was dissected in a 1934 report, often called the *Alger Report*.[7] The Report was named after George W. Alger, who conducted the final autopsy of the industry for Governor of New York Herbert H. Lehman, (with the aid of counsel Alfred A. Cook). This history, with its catalogue of abuses and misjudgments, has been the cornerstone of all regulation, which only recently shaped the institution of mortgage loan insurance.

The statistical experience provided by the Mutual Mortgage Insurance Fund (MMIF) of the Federal Housing Administration provided data as background for the premium and reserve assumptions of mortgage loan insurance. A synopsis of the *Alger Report*, below, should provide much insight into the origins and content of current regulatory objectives in regard to mortgage loan insurance.

The business of mortgage investment guaranty was born out of wedlock with the law, in an arrangement of convenience

[3] Classification as insurance might be withheld, pending examination of its relevance to the loan guaranty.

[4] Professor Thompson is an associate professor of management in the School of Business, University of Wisconsin, specializing in computer controls and mathematical models for operations research.

[5] Professor Heins is a full professor of insurance in the School of Business, University of Wisconsin.

[6] WIS. ADM. RULES 3.09 (1).

[7] 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 State Insurance Department.

whereby a poorly worded stretch of the New York State 1885 Statutes in regard to title insurance was misinterpreted to permit the guaranty of mortgages against loss for reasons other than title defect. By 1895, at least four large mortgage banking firms allied with title companies were offering guaranties of "prompt" payment of the interest for mortgages which they had marketed to small investors. In 1904, the statutes adopted the ill-starred infant by amendment, granting title insurance firms legal standing to insure "the payment of" bonds and mortgages. The phrase was inserted in the prior title insurance law of 1892, which had been drafted to disenfranchise the guaranty by restricting the 1885 law to traditional title insurance.

Since title insurers had traditionally experienced only negligible losses, their required reserves were minimal in relation to gross liability. Entry capital was generally less than for any other insurance line. As a result, the guarantor was required to maintain no other reserve funds except the non-segregated guaranty fund to equal two-thirds of its original capital or about $67,000, as required to write title insurance. In 1911, the insurance law was further amended to permit title companies "to invest in, to purchase, and to sell with guaranty of interest and principal or with guaranty of title, such bonds and mortgages as were legal for insurance companies."

Rather than require an investment banker or trust department which wished to sell guaranty mortgages, to be licensed as an insurance company, a guarantor could be organized under either the insurance or banking laws of New York, or both. While a majority of mortgage banking firms registered under insurance laws, it was possible to organize under the banking law with only $100,000 capital. At least two New York commissioners of insurance stated publicly that the guaranty could not be considered insurance but was rather a misplaced responsibility of the Banking Commission.[8]

Following the 1911 legislation, title companies and allied trust companies began to sell guaranty mortgages for which interest was guaranteed on the date due but principal restitution was deferred 18 months after mortgagor defaulted on principal repayment. This was to allow time to foreclose and resell to generate cash for replacement of principal. Payment of defaulted taxes and foreclosure expenses were never guaranteed, but some companies found it expedient to represent that they would "attend to payment of taxes and assessments," an airy legal flourish which many investors mistook for additional guaranties.

An ill-defined legislative afterthought was added in 1913, to the effect that the power to guaranty mortgages was applicable only to those sold by the originating mortgage banker-guarantor on "improved and unencumbered single property worth 50 per cent more than the amount loaned thereon." Note that loan decisions and guaranty underwriting were all under one roof. This provision not only created unresolved debates on the definition of "improved" property, but also encouraged accommodating appraisers to win mortgage banking business by inflating appraised values in relation to actual construction cost.

A favorite guarantor security was the small denomination, participation certifi-

[8] The insurance commissioner of Wisconsin, on the other hand, one W. Stanley Smith, in 1926 recognized the guaranty of mortgages as insurance under both sub-sections (7) *surety* and (8) *title* insurance of Section 201.04 of the Wisconsin Statutes. The regulation of the guaranty business was furthered with the aid of the Securities Division which would not recognize guaranty mortgage bonds for legal investments by Wisconsin Fiduciaries unless the guarantor were in good standing with the Wisconsin Insurance Department. By 1930 none had such approval, and losses in the next five years were at a minimum for Wisconsin investors in this kind of security.

cate in the single large mortgage or large mortgage portfolio. As early as 1906, small investors purchased notes which were issued under an indenture which made the guarantor irrevocable agent in the exercise of the mortgagee's rights in his property pledge. The group series certificate purported to assign the holder an undivided interest or share in a specified amount of a bond-mortgage portfolio. The guarantor generally served the portfolio in the double role of trustee and depository, reserving the right to withdraw and substitute any mortgage in the group. These substitution privileges were intended to permit management of the portfolio and refinancing of what were short-term balloon mortgages without disrupting the continuity of the investment trust.

These powers were not seen as dangerous so long as the unblemished record of the guarantors led to tremendous expansion of the industry during the 1920's. However, the right of substitution enabled the guarantors on the brink of insolvency to loot portfolios of good mortgages for sale to insurance companies[9] in exchange for cash and sometimes weakly secured or defaulted mortgages as boot. The cash was paid as periodic interest to certificate holders who seldom knew that the actual mortgage loan, in which they held a beneficial interest, was in default or that their collateral was being diluted or liquidated.[10]

As early as 1924, a number of foresighted individuals were critical of policies and practices in the guaranty industry. However, an amendment in the New York legislature to prohibit sales of participation certificates in defaulted mortgages never came to a vote. As late as 1929, an act to impose a capital-to-liability ratio to control too rapid expansion died in legislative committees. Indeed, the legislative history of the investment guaranty was testimony to the ease with which its politically astute management achieved its legislative whims for lack of any voting block favoring certificate holders.

Autopsy

The disintegration of the real estate market from 1928-34 led to wholesale mortgage defaults which, in turn, led to intolerable cash drains on investment guaranty resources. Liquid assets were sufficient to make "on-time payments" of interest on defaulted mortgages for several years, so that many investors in guaranty securities were unaware of the status of the underlying collateral. The stripping of cash resources from the guaranty network enhanced the image of the guaranty with the small investor by 1932, whose continued purchases of such securities prolonged the agony and postponed decisive regulatory action.

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 mortgage and real estate security guaranties for 225,000 individual investors in that state alone. New Jersey, California, and Massachusetts, and a few other states had additional losses to an unknown degree.

State action was several years too late to mitigate the disaster, for it had lost control for lack of adequate, current, audited financial data. The record revealed that one career man had been responsible for the statutory examination of guarantors for 25 years, without specific instructions other than to make "a full

[9] Some of the larger insurance companies took advantage of the guarantors to dump defaulted mortgages and purchase good securities at discounted cash prices.

[10] Mortgage investment guaranty management always assumed a short depression and thereby justified any move which produced cash in the short run or fostered public confidence to save the company until prices rose magically to former levels.

and complete examination of the company."

Examinations never extended to subsidiary corporations, which were frequently used to hold foreclosed real estate (to keep it off the books of a land-poor parent company) and to hold defaulted mortgages, assets paid for by transferring stock shares or notes of the subsidiary to investment accounts of parent firms. Far worse was the practice of subsidiaries to pay interest on notes or defaulted guaranty mortgages by issuing a note to the parent company. This amount was added to receivables and to income and thence to earned surplus. Dividends were then paid stockholders from such surplus to parody the concept of "financial solidity"[11] until firms went into receivership!

Foreclosed properties were put on the books at face value of the foreclosed mortgage, plus interest, taxes, and foreclosure expenses. Thus the balance sheet surplus position of the parent firm was unaffected and disclosed nothing in the way of real estate holdings. Examiners valued mortgages and subsidiary notes on the books of a parent corporation at par, even though they were in default or in the process of foreclosure, on the assumption that properties were 50 per cent greater in value than the note foreclosed.

The examiners did not consider the guaranty of mortgages a contingent liability subject to audit or loss reserve. One company, having outstanding guaranties of $900 million, had heavy foreclosure losses, but no loss reserve or mention of the scale of guaranty exposure on the balance sheet. The absence of reserves for shrinking real estate values or increasing uncollectable receivables made analysis of income statements futile, so that the prudence of cash dividend payments to stockholders went unchallenged.

Guaranty companies were often organized within an intricate corporate network of mortgage companies, development companies, and title companies financed by trust companies, which in turn, were allied with the banks and shared the same officers, directors, and business location. Advertising of the guaranty was intentionally fuzzy as to the exact assets and to the functions of each firm in such a chain, so that many savers who purchased certificates thought their guaranties were from a bank or trust company.

Trust companies found the advertisement of their use of the guaranty useful to foster the image of conservatism, to increase the retention of service fees, and to cloak conflict of interest situations. Following the collapse of real estate prices by 1930, banks, as a matter of self interest, tried to forestall collapse of their allied guaranty firms by making large cash advances. This allowed the guaranty industry to prolong the delusion and to compound the losses of all concerned.

A Judgment

During the 1920's, the real estate aspects of the mortgage guaranty conformed to the general practice of inept appraisal, high leverage, and, in at least one case, over-certification of a mortgage portfolio. However, integrity of management did not actually break down until 1932 and 1933, when desperate executives found hope of continued liquidity in reselling at par, for cash, their own securities to the uninformed small investor, securities purchased in the money markets at great discount.

Their advertising copy men, in the tradition of the great American patent medicine man, described guaranty first mortgages, as late as 1932, as "pure gold"

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[11] "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.

or "absolutely safe" and "horoscope not needed" and there was "no watching" required. An ad in 1931 urged the use of $100 group series certificate for children's savings and for Christmas gifts to grandchildren. The executive of the enterprising firm who sought the financial support of infants, admitted in the investigation that at the time he was running such an advertising campaign, he switched the investments of his own family to government bonds!

Such incidents were the acts of ordinary men in the stress and despair of extraordinary circumstances. Indeed, many of the guaranty firm leaders sincerely believed that real estate prices would return to more normal levels (i.e. 1928 levels) at any moment, if liquidation could only be forestalled until collateral resales would offset guaranty obligations.

Whatever the motivation, the investigation of such incidents created a pall of terrible scandal, an image of financial black magic and chicanery, which survived to haunt the mortgage loan insurance program of the present day, conditioning both regulation and market responses. Still, the investment guaranty was no test of the applicability of insurance principles, since none was ever employed in the line. Indeed, there is no real evidence that the guaranty would have failed if the appraisals on which they were based had been honest or competent pieces of work.

The Legacy

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, as New York chose to legislate in response to investigation of the scandal. Rather, these men recognized the basic flaw as the short term balloon mortgage itself. They 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, or brokers.

In addition, these analysts felt that there was need of a guaranty procedure which would provide accurate appraisal, personal penalties for lending malpractice, underwriting criteria, and a limited ratio of contingent liabilities to capital and surplus. Of course, it was also recommended that sizeable reserve funds be set aside in investments not subject to severe price cycles. Ironically, the *Alger Report* did not shape legislation or regulation to such an end until more than twenty years after it was written. Only since 1956 has it served as the basic primer for state insurance regulators puzzling over new proposals for mortgage loan insurance.

The Maternal Ancestor

The creation of the Federal Housing Administration (FHA)[12] in 1934, as handmaiden to lenders adopting progressive lending practices and loan forms, eventually made possible the reconsideration of mortgage loan insurance in 1957. 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

[12] For a thorough analysis of the FHA conventional residential mortgage loan insurance see *Mutual Mortgage Insurance Fund* (MMIF) by Ernest M. Fisher and Chester Rapkin, 1956, Columbia University Press, New York. The insurance of MMIF is the only section of the FHA Program which is directly comparable to the sphere of interest of the privately financed mortgage loan guarantor.

was set at one-half per cent of the outstanding loan value at the beginning of each year, payable monthly over the life of the loan. In addition to the requirements of administrative reserve expense, this premium base provided for both a basic insurance reserve and in the case of MMIF for Section 203 loans, a participating reserve account for the payment of terminal dividends on an actuarial share basis to mortgagors at the time they pay off the mortgage. The actuarial formulas included detailed assumptions as to real estate price levels, annual foreclosure frequency and cyclical annual foreclosure loss severity, reflecting depression magnitude losses, and annual group loss experience. While economic events of World War II and the subsequent expansion of demand for and price level of homes, may have outdated these actuarial assumptions,[13] nevertheless the FHA formula did represent an attempt to apply insurance principles.

Initial discontent with the FHA program was not concern for costs relative to benefits, but, rather, chafing at the FHA takeover of inspection and appraisal responsibility, and administrative proscriptions on the lending operations of mortgage bankers, most particularly the savings and loan lenders.

The savings and loan industry was uncomfortable with the hidden financing charges of the discount system caused by non-market interest ceilings on FHA-VA mortgages. The appraisal and credit analysis by FHA usurped the discretion of savings and loan officers and their role as representatives of the home owner. Many lenders felt that the mutual features of the FHA Mutual Mortgage Insurance Fund were seldom understood by borrowers, increasing borrower resistance to the ½ per cent charge, after many years of prompt payment, and borrower susceptibility to overtures of other lenders to refinance at lower rates once substantial equity had accumulated.

Eventually the huge reserve accumulations and minimal losses of FHA[14] attracted the notice of New York financiers, who saw both a need for a private guarantor for savings and loan markets and a real profit potential. Such plans as they might have had (known only from trade hearsay) were quickly blighted and lost for the record by the firm New York law against such an enterprise, a law once amended with reluctance to permit the VA program within New York borders.

By 1955, the savings and loan industry was beginning to feel the pressure of growing investment reserves, attracted by increasing dividend commitments, relative to the supply of available loans at conservative loan ratios and generous interest terms. It became mandatory to lend more dollars at each opportunity to offset investable funds increasing at a rate more quickly than mortgage investment opportunities and to justify higher than average interest rates with liberal ratios to cover dividends, reserves, and overhead.

[13] More recently, actuarial theory and insurance feasibility have taken a back seat to social theory in the administration of FHA programs which are not part of MMIF.

[14] During the year reviewed by the private guarantor book in 1955-58, the FHA had offered ten separate programs of mortgage insurance, the total income from which amounted to more than $1.2 billion by mid-1957. Seventy-three per cent came from premium and the remainder from investment and fees. Expenses were 47 per cent of earned premium, including 8 per cent for losses. The largest continuing program, and the one most analogous to private insurance, was the Mutual Mortgage Insurance Fund (MMIF). By June 30, 1957, MMIF had collected $758 million, 72 per cent from premium, 19 per cent from fees, and less than 9 per cent from other sources. Administrative expenses alone of more than $308 million amounted to 41 per cent of total income and to 56 per cent of premium income. Only $4 million had been used to meet losses on acquired property. Page 324, "The FHA Mortgage Insurance Premium—An Analysis and an Alternative," *Study of Mortgage Credit.* Subcommittee of Banking and Currency, U.S. Senate, First Session, 86th Congress, Government Printing Office, 1959, Washington, D.C.

In many cases the net income of savings and loans relative to dividend commitments left little margin for a possible increase in foreclosure losses or a reduction of investment returns through acceptance of low interest government bonds, with which FHA insured situations were indemnified.

A Broken Engagement

In 1958, the U.S. Savings and Loan league secured introduction of a proposal, specifically Title VII of the original 1958 Housing Act, to create a home mortgage loan guaranty subsidiary to the Federal Home Loan Bank, to initiate a program tailored to meet the objection to the FHA program. It was proposed that a guaranty would be provided for only the top 20 per cent of the mortgage principal and interest of a loan exposure, with coverage to last for only the first ten years. First year premiums and renewals were to be on an annual basis, or on a single premium plan, with option of cancellation and a short rate refund.

There were to be no interest ceilings, and underwriters for the guarantor were to base their decision on a review of appraisals and other credit reports by the lender, reports subject to spot checks and enforcement penalties. Banking interests secured amendments to provide a 6 per cent interest ceiling, federal appraisal, and federal property inspections of new construction. The result was that the savings and loan interests disclaimed their own bill, which failed by a small margin to become part of the 1958 bill.

Nevertheless, the new approach of the partial guaranty and an expeditious underwriting technique had been discussed frequently and enthusiastically within the savings and loan industry for several years prior to the abortive legislative putsch, so that industry leaders were favorably conditioned to such an approach. By 1957, resistance to the FHA underwriting method and interest ceiling had hardened at the same time that the need for high ratio home loan investments was apparent. The power to make such loans was becoming available in changing federal and state savings and loan investment regulations.

Then there was the subtle motivation of optimism attributable to the resurging confidence of the savings and loan industry, accompanying its powerful expansion within the consumer-savings, home-lending market, or perhaps to the prevalent attitude of the Eisenhower era that "big business" could do almost anything better than "big government." For whatever reason, people were ready to listen to a proposal for private mortgage loan insurance and to set aside the experience of mortgage investment guaranties as a memory of mortgage banking adolescence.

Private Mortgage Loan Guaranty Plan

The creation of a private mortgage loan guarantor as an operating reality can be attributed in large part to the inventiveness and drive of a Wisconsin real estate attorney, Max Karl,[15] experienced with the strong Milwaukee savings and loan fraternity. After a year of study, he submitted his proposal for a guaranty plan to the Wisconsin Insurance Department in late 1956. He found a rationale in the FHA experience, the activities of the Savings and Loan League on behalf of Title VII, and miscellaneous actuarial projections. However reluctant the Wisconsin State Insurance Department was to risk its reputation on such an unproven concept (reflecting on the 1934 scandals), it was not unmindful of the potential premium tax income which could result from such a successful firm. Also there was professional curiosity among its able technicians as to the feasibility of such programs.

[15] Mr. Karl continues as the President of MGIC and leading statesman of the fledgling industry.

Responsive to the impressive FHA record and the limited endorsement of the *Alger Report*, the insurance department chose to introduce the unprecedented insurance operation within the controls of a new section of the administrative code.[16] This could be modified quickly to meet any situation, simply by announcing a public hearing and then a ruling by the Commissioner. A license was issued upon an interpretation of the title insurance enabling statute[17] by the Attorney General. As this classification was objectionable to other state insurance departments (where capital requirements remained at pre-1929 levels) Wisconsin Insurance Statutes were amended to include specifically the guaranty as a branch of credit insurance.[18]

In 1965, Wisconsin Law was amended with the encouragement of state-based guaranty firms to create a separate line of mortgage loan guaranty insurance with its own capital requirements.[19] The exchange between the sponsors of private mortgage insurance and state regulation agencies has been essentially a creative and refreshing interlude in regulatory-industry relations.

Underwriting Plan

The underwriting program for mortgage loan guaranty insurance has three basic elements: (1) selective qualification of eligible lenders, (2) selective review of basic information submitted with an application for guaranty insurance for individual loans, (3) constant spot checks of local economic factors, lender appraisals, and credit reports. A master policy is issued to qualified lenders, specifically those who have state or federal supervision, regular daily business hours, a certain minimum size, demonstrated management ability, and appraisal sophistication.

Approved lenders may then submit individual loans to be insured or rejected on a case basis, with a certificate of commitment or of insurance issued for each qualified loan. For each loan, the lender submits a copy of the loan application, the proposed terms, a credit report, supplemental information on borrower income and fixed expenses and an appraisal of the real estate by the lender.

With the aid of a few key ratios, caveats, and current local market surveys, an underwriter will accept or reject the submission by return mail.[20] With the aid of local independent appraisers, appraisals have been spot checked and credit reporting agencies tested as to reliability, initially for one out of every five accepted applications although presently spot checks would be made on a ratio approximating one to fifteen. Lenders who appear to misrepresent properties are dropped from further participation.[21] In addition, the company has done regional and municipal economic studies which may result in certain communities falling out of bounds for coverage.

This relatively simple underwriting network, involving the home office and in some cases the regional underwriting office, reflected a basic assumption of the private guarantor, derivative of FHA experience. If the FHA record were studied for the conventional loan with 10 per cent or more downpayment and for programs without intent to provide ownership for special groups, then it would be argued the marginal cost of assuming the total

[16] WIS. ADM. RULES 3.09.

[17] WIS. STATS. 201.04 (8).

[18] WIS. STATS. 201.04 (9).

[19] WIS. STATS. 201.04 (19).

[20] Long delays on committments were a constant irritation for those using the FHA program in the mid-1950's, as Congress failed to appropriate sufficient funds for adequate staffing.

[21] In several cases, where savings and loan institutions in Chicago were in the process of disintegration due to fraudulent operations, MGIC had suspicions, from spot checks, a full year before these institutions were closed by federal auditors.

appraisal, inspection, and credit analysis burden to standardize and control the mortgage loan process was not justified[22] by a corresponding marginal saving in terms of foreclosure loss avoided.

The private guarantor assumed that his administrative savings would be far greater than the cost of his underwriting errors, thereby justifying issuance of a guaranty for the high ratio loan at a cost significantly lower than comparable FHA coverage. The private guarantor has generally charged ½ per cent of the initial loan balance for the first year, and ¼ per cent of the opening loan balance for each of the next nine years, should the lender care to renew each year. A single premium plan has also been available from the outset for 2 per cent of the initial mortgage balance, a charge which would be included in closing costs. This charge could be refunded should the lender cancel on a special short range basis. In addition, an appraisal fee of $25 has been charged for loan applications involving an 80 per cent loan to value ratio, or better.

The maximum acceptable loan would be 90 per cent, although subordinated or collateralized debt would be permitted up to 95 per cent of appraised value, so long as debt service, disposable income and other factors remain within the single mortgage standard. A single premium renewal contract covering the eleventh through fifteenth years was contemplated initially, but now ten years later, the termination rate on coverage has been such to suggest elimination of any effective demand for the extension period coverage.

The Contract

Certainly the contract represented a new standard for clarity and brevity for agreements among financial institutions, with about 20 clauses and a short rate table spaced over four pages.[23] Coverage for the lender contemplated an amount determined as: (1) interest on the mortgage balance until title is transfered to guarantor (excluding penalty interest), (2) real estate taxes, insurance premiums and maintenance expenses necessary to carry the property until clear title can be transferred to the guarantor, (3) court costs of foreclosure, (4) attorney fees not to exceed 3 per cent of the balance due, and (5) in lieu of the above a reservation of the right to pay only 20 per cent of the claim as determined above and a waiver of the claim to the real estate by the guarantor.

This coverage would be non-cancellable by the guarantor for ten years, renewable each year at option of the lender. The lender would be expected to notify the guarantor of a delinquency within four months of the onset. Foreclosure action need not start until the total balance in default were equal to nine monthly payments, thereby reserving considerable discretion to the lender.

Letters of commitment for payment financing of new construction have long been available and open-ending accomplished following a review by the guarantor underwriter.[24] For the benefit of the borrower, expected to pay the premium, state statutes generally have required that the policy relieve owner-residents from any deficiency judgment action by the guarantor following foreclosure and resale.[25]

[22] It must be remembered original guaranty plans were based on the FHA operating record through 1956, before the impact of very low downpayment loans caused foreclosure frequencies to rise significantly.

[23] The typical contract in use is substantially the same as drafted by Max Karl in 1957, save for the 20 per cent option, which was introduced in late 1958.

[24] In some cases lenders on small rental buildings have asked to open for principal in default and have cancelled in pique at the turndown.

[25] The lender may retain the right to a deficiency judgment in states where the waiver is not required by law but only as a result of a standard guaranty contract. Such an oversight would appear unfair to the borrower.

Marketing

At the very beginning, the guaranty was sold through district agents with subagents who serviced one or more lenders, predominantly savings and loan lenders, as other lending institutions were subject to conservative investment regulation, conservative directorship, or loan correspondent contracts with sufficient geographical dispersion to "self-insure." However, it became possible to distribute master policies through salaried district representatives and most sales are now made in that manner.[26]

At first, many savings and loans were reluctant to make any loan in excess of a 70 per cent ratio, with or without a guaranty. The marketing problem was to educate the lenders to standard appraisal, credit, and loan committee standards appropriate to the low down-payment home. Often the guaranty served as an aid to the young, aggressive loan officer in his effort to secure more liberal lending standards from an older, conservative board of directors.

As saving and loan lenders gained experience and confidence, they began to assume the risk of the high-ratio, quality loan and simply to insure the more marginal situations. The guarantor began to receive a smaller proportion of a lender's mortgage volume, a higher average loan ratio, and more marginal credit reports. Lenders often used the rejection by the guarantor underwriter as a polite way to say "no." In short the marketing question has become primarily concerned with avoiding adverse selection by qualified lenders. Not only have lenders tended to reduce offerings to the guarantors but have tended to cancel coverage at an earlier date.

When the only high-ratio loans permissible to a supervised lender were FHA-VA loans, the lender was required to submit all such proposals to FHA. Today the lender may choose among FHA, VA, the private guarantor, or assumption of risk alternatives. Worse, the lender could submit the loan to several guarantors which might compete for a restricted market by relaxing underwriting standards.[27] Potential for adverse selection has remained as one of the major problems for the guarantor and the regulator.

These marketing trends might cause the guarantor to change to a five year single premium non-cancellable plan, in addition to adopting underwriting rules requiring approved lenders to submit a certain minimum number of acceptable loans each year. A large number of lenders have carried the master policy of one or more companies, at no cost to the lender, without using the service at all or simply as a third party, negative decision-making device.

Another aspect of marketing has been that of encouraging regulatory agencies to liberalize loan ratio requirements for credit unions, pension funds, trusts, and banks, so that more institutions would consider high ratio loans with a private guaranty. In 1954, national banks received permission to make a few 90 per cent ratio home loans, if insured by a public or private guarantor for at least the top 20 per cent of the loan. The advent of tight mortgage money and higher than average commercial and consumer loan activity has given banks little cause to use this privilege. Market development includes legislative reform of acceptable loan insurance for fiduciaries in any given state, such as this suggested clause from a model legislation format circulated by the management of MGIC:

[26] Some states prohibit payment of a commission or placement of an agent within lending organizations.

[27] The new company might hope to win friends by accepting loans others might refuse, anticipating that, with time, reciprocity and inflation might offset losses in future higher premium volumes.

> Investors in residential mortgage loans shall be exempt from any statutory loan to value ratio limitations provided the loans are guaranteed by the Veterans Administration, or insured against loss by the Federal Housing Administration or *any mortgage guaranty insurance company licensed to transact business under the insurance laws of this state.* (Author's emphasis)

Where lending controls have not been relaxed, new financial institutions have been created. For example, in Canada insurance companies have been limited to 67 per cent loans. A mortgage banking firm, encouraged by MGIC, developed a "piggy-back package" of a 67 per cent first mortgage note for the insurance company and a 23 per cent ratio note insured by MGIC for the investment company. Both notes were to be secured by a first mortgage giving liquidating priority to the insurance company portion.

An unfortunate aspect of an increase in market due to regulatory action has been the rapid increase in the use of private mortgage guaranty insurance in the South, to avoid the open occupancy requirements of FHA programs. Should federal proscription of discrimination be extended to loan policies for federally chartered lenders, the market for the guaranty with government supervised lenders would probably evaporate as various private mortgage banking subterfuges were initiated.

The potential market for the use of private loan insurance has been slotted between regulatory restriction on high ratio loans, the degree of resistance to current government sponsored programs, and the supply of money in excess of the demand for low ratio loans. This is an artificial market, dependent on administration rule, custom, and shifting investor mood.

Perhaps the major marketing success to date has been the ability to convince the savings and loan industry that a firm, or the guaranty industry itself, can provide security for the lender due to the dispersion of risk by the guarantor, with only 4 per cent reserves, when the average savings and loan lender has uncommitted surplus reserves equal to 6.6 per cent of outstanding mortgage liabilities.[28]

Loss Adjustment Methods

A loss claim would involve both the accounting problems of creating proper reserves and the operational problems of correcting defaults, acquiring foreclosure property, and disposing of property acquired. Within the latter set of related problems, the MGIC management finds a letter or a personal visit has been sufficient to motivate the borrower to maintain his payments in more than 50 per cent of reported delinquencies. Delinquencies should be, in part, a matter for control by skilled portfolio management by the lender. More serious defaults have often been settled by effecting resale or voluntary transfer to the lender. The remainder, perhaps $\frac{6}{10}$ of 1 per cent of loan volume in force and only half of reported delinquencies, have entered foreclosure, a process ranging from 1 to 18 months in the various states.

Initially the company expected to take title to most property and reserve the 20 per cent of claim limitation for use only in times of recession, the company preferring partial liquidation of assets to a transfer of assets into non-liquid real estate. However the cost of managing and negotiating sales in various parts of the country was not always justified in terms of the net reduction in loss[29] relative to cash payment of the 20 per cent award. As the number of properties within

[28] *Fact Book*, 1965, U.S. Savings and Loan League, p. 90.

[29] The net at risk to the mortgagor is the difference between price indemnity of the lender under the contract and net proceeds on sale of acquired property by the guarantor. Changing real estate price levels theoretically require the guarantor to time sales to seasonal and cyclical price peaks for each community.

the claim process grew, the company found it expedient and economical to pay 20 per cent of the claim and to allow the local lender to resell the property for the remainder of his cash investment. While such a step might leave the lender without full indemnity for his own appraisal error, in most cases the lender has been able to dispose of the property for more than the 80 per cent balance due. The result is that a lender may profit to a small degree on the foreclosure situation, bending the principle of indemnity.

Such an opportunity has been proven preferable to the FHA payment in low interest, federal funds with a maturity date parallel to the defaulted mortgage term. In many states such a practice could violate the principle of indemnity. In some states, such as California, the law has prohibited the guarantor from paying more than 80 per cent of the net loss to the lender on resale, not to exceed 20 per cent of the full claim, making the co-insurance feature applicable in all cases. Partly as a result of the decision to pay the 20 per cent option, the severity of loss has risen from a negative figure in 1957 to an average of $2,600 per case[30] in 1965. Administrative costs have been avoided and the value of property retained has involved a smaller proportion of assets than was first anticipated, increasing investable funds and investment income.

From the accounting viewpoint, loss reserves would best be divided into three sub-accounts including:[31] (1) Estimated losses on insured loans which have resulted in the conveyance of property which remains unsold, (2) Insured loans in the process of foreclosure, and (3) Insured loans in default for four or more months.

In each case the loss would reflect the difference between a current independent appraisal of the property, adjusted for net resale proceeds after commissions, taxes, and maintenance and the estimated claim to be made if and when foreclosure were completed. The frequency of loss has fallen, while the severity per loss has been rising as a result of changes in underwriting policies. Early in its career, MGIC made commitments on several subdivisions and apartment projects which proved unmarketable, and heavy loss reserve allocations were only avoided when key stockholders took over the projects from insolvent contractors.

Largely as a result of this experience, some states prohibited the issuance of guaranty policies in excess of 10 per cent of surplus for a single tract or contiguous areas "not separated by more than one-half mile." Intra-company studies indicate insurance commitments generally ripen into claims within four years and are generally the product of a faulty appraisal, an incomplete credit report, or a reduction of employment by a major local employer.

Management Resources

Key management personnel to staff the new guaranty insurance industry have largely been drawn from the law, appraisal, government regulatory agencies, and real estate trade organizations. In addition to the lawyers, influential leaders of the industry include two former state insurance commissioners, several state FHA directors, several nationally recognized appraisers, well known local realtors or loan officers, and several former regional directors of mortgage lending trade associations.

It is perhaps premature to judge management effectiveness, as it has yet to be tested by the pressures of prolonged recession, broad scale competition, or reliable industry expense ratios. However, the evolution of the financial structure of the

[30] Based on review of only three company loss reports for 1965.

[31] Required by statute only for companies choosing to be licensed in California.

early guarantors does give some indication of the creativity of early management and of current management concern for adequate regulation to prevent the failure of an under-capitalized, over-promoted, guaranty firm, to the discredit of all mortgage guaranty insurance.

Development of Guarantor Financial Structure

Those most familiar with the financial dilemma of a mortgage guarantor, have advocated minimum capital for entry into the line of $1 million of capital and $1 million of paid-in surplus,[32] derived from a single class of common stock of one-line company. In part, these standards reflected the desire cf many regulators to advance all insurance company minimum capital requirements to reflect current dollar values, but in large part these standards were suggested by the financial path of the first guarantor, MGIC. A brief biography of the financial moves of this pioneer has been quite instructive for students of insurance finance in general and some modern day regulators in particular.

Financial Biography

Licensed in mid-February of 1957, MGIC began with $262,500.00, only $12,500.00 more capital than the minimum required, capital raised in bits and pieces from a small coterie of Milwaukee real estate investors. To avoid the inroads on surplus, an expected element of all insurance start-up and acquisition costs, MGIC was actually two corporations, a licensed insurance company and an independent marketing corporation. This separate corporation, Guaranty Insurance Agency, Inc., was capitalized by requiring investors to purchase one Agency share with each four shares of MGIC stock.

By contract, Agency organized all sales functions for MGIC, for which it received commissions on a premium earned base rather than a premium written base. In addition it received required appraisal fees and purchased necessary appraisal spot checks. Since Agency paid its sales representatives on the basis of premium written, the difference between receipts and disbursements was financed from bank loans and a surplus deficit. Since the ownership of Agency by MGIC shareholders removed Agency from regulation by the insurance department as a subsidiary, the bank financing of acquistion costs of new business did not appear on MGIC statements.

In Florida a new, non-domestic insurance corporation must have operated successfully for three years outside of Florida before becoming eligible for licensing in that state; domestic subsidiaries of an ineligible foreign insurer were also excluded. Agency, however, was not an insurance corporation under Florida law and so it organized an MGIC of Florida, capturing an important residential mortgage market. MGIC of Florida was quickly liquidated by merger into the parent MGIC organization as soon as MGIC became approved in Florida in the spring of 1960.

Agency itself was liquidated in October of 1960, reflecting a change from a commission schedule to direct salaried representation, a stronger MGIC surplus position, and a tacit recognition of the irritation of regulators with regard to Agency as a satellite (if not a subsidiary) of MGIC. At this time MGIC created a wholly owned subsidiary of Mortgage Finance Corporation (MFC). It was intended that MFC provide the real estate appraisals and economic analyses funded by the appraisal fee which accompanied each application for a high ratio loan.[33]

[32] These are the California requirements; typical other state requirements are Wisconsin, $900,000 capital $450,000 paid-in surplus; Florida $500,000 capital $250,000 paid-in surplus.

[33] These fees, which at that time were $20 for each application, represented a major source

If these fees were paid directly to MGIC, there was the chance of classification as similar to a mutual membership fee or underwriting fee, which Commissioners in Wisconsin and elsewhere regarded as additional first year premium, subject to monthly reserve allocation to income, thereby postponing their impact on surplus. In addition, it was expected that MFC would acquire at cost, property to which title had been taken by MGIC due to full payment of a guaranty claim. MFC could operate the property as a rental unit, providing depreciation tax cover for appraisal fee income, or sell the property under land contract, recovering the dollar investment in the property over the long term. MFC expected to finance the property holding operation with lending agencies in the locale of each property, while MGIC would experience no book loss on claims so handled.

Wisconsin insurance audit procedures treated MGIC holdings of MFC stock as an inadmissible asset, so that real estate held by MFC and attendant mortgage borrowing would not appear on a consolidated MGIC balance sheet. MFC was motivated primarily by tax considerations and the need to tap mortgage funds to maintain property holding inventories. It was easily identified with the property holding shadows of the mortgage investment scheme of the 1930's, an unfortunate connotation in light of the Alger Report warning against subsidiaries of any kind. Apparently state regulators made their feelings known and MFC was dissolved. Appraisal fees were treated as premium income by 1963 and company loss adjustment policies were altered to favor payment of claims in cash under the 20 per cent option.

The concentration of all functions within MGIC paralleled a steady expansion of its equity base through sale of common stock. The original no par value shares were successively transformed, through stock splits, to \$80 par, \$10 par, and \$1 par shares, which served both the sale of stock and the need for additional surplus, drained by continual expansion. Sale of stock was at first limited to Wisconsin, underwritten entirely by MGIC, and at one point a technical violation of federal security laws required a tender to repurchase all outstanding stock; no tenders resulted.

By 1960, there was an over-the-counter market for MGIC shares in the Milwaukee area, but shares were scarce and an understanding of MGIC even more rare so that prices fluctuated wildly, with a few sales recorded at \$50 per share for stock that might have cost the early investor about \$1.60. A New York investment banking firm was called on to manage and underwrite an ambitious equity capital program in 1961, at which time about \$5.5 million in equity was generated through sale of 236,000 shares at a price of \$27 per share. Another stock sale was accomplished in 1963 at \$30 per share for an additional \$6 million of capital. The surprising capital appreciation enjoyed by early investors has been a prime incentive for the organization of imitators of MGIC in various sections of the country.

Oligopsony

The first guaranty firms found a market for stock shares among people associated with the savings and loan industry and in 1964 the Home Loan Bank conducted an investigation[34] of the relationship of

of revenue when it is remembered that applications reached 10,000, 15,000, and more during these years, most of which required payment of the fee.

[34] MGIC officers had once facilitated a bank loan to one Robert Baker, an administrative staff man in the U.S. Senate, with which Mr. Baker purchased shares of MGIC at the then registered stock price. Subsequently stock splits and market action produced a profit for Mr. Baker which was a subject of inquiry as part of a broader investigation, which in time precipitated some parallel inquiries by other federal agencies of firms

the use of the guaranty to the stock ownership position of lending officers.[35] The investigating board concluded there was no "statistical proof"[36] of any conflict of interest between stock ownership in a guarantor and decisions by loan officers to require the use of such insurance in any given loan situation.

However, the most significant element in the financial structure was not the skillful expansion of common stock ownership, but rather the daring expansion of the guarantor market and political constituency in exchange for a degree of financial control. In 1958, when the plan to be operated by the Home Loan Bank was scuttled in Congress, MGIC was an operating fact in at least eight states, offering an insurance plan identical to that proposed for the Home Loan Bank, (save for the $20 million of capital).

On the initiative of the Milwaukee group, MGIC expanded its board of directors to twelve and seated seven former presidents of the U.S. Savings and Loan League, including Henry A. Bubb as Chairman of the Board,[37] the leading Washington exponent of the Home Loan Bank guaranty proposal. Representing all sections of the country and well-known to all major savings and loan institutions, the directors gave the firm national visibility, a preferred market position, and an access to the major capital money markets.

This ploy represented one of the clearest demonstrations of current insurance financial strategy, specifically that corporate control rests with those who have market access and not with those who own the largest number of shares. Growth for any new insurance company has been best achieved by means of a captive market or captive sales force. Despite these indirect ties to the most effective political force representing the savings and loans, the League was careful to disclaim any endorsement of MGIC and forbade its employees to have any financial interest or other tie which might be construed as tacit approval.

Contact was made with the savings and loans on a large scale, at the same time that their lending restrictions were liberalized to permit successively higher loan ratios, reaching 90 per cent, 30 year term, $26,500 limitations by 1959. Therefore, just as MGIC was receiving an infusion of capital, an image of established respectability, and a more favorable reception by state insurance regulators, the volume of mortgages made at terms appropriate for the use of guaranty insurance mushroomed.

Timing was perfect, and insurance written approached $2 billion before the end of 1964. As will be shown, success engendered a new threat to the industry when California imposed a maximum liability-to-policyholders surplus ratio for companies licensed in that state. If certificate termination had not exceeded expectations, total insured mortgage volume for MGIC would have reached its ceiling and forced premature additional equity financing.

Unless stock offerings were staged to await increasing stock prices, growth would require new equity, diluting existing equity interests in the contingency reserve and undermining the price per share and absorption of stock offerings. Without

known to have been acquainted with Mr. Baker. There has been no evidence that Mr. Baker was able to reciprocate the favor for any mortgage guarantor, and newspaper reports that his interest secured income tax exemption of contingency reserves is in direct conflict with facts and dates established by records available to the author.

[35] *Statement of the Federal Home Loan Bank Board on the Inquiry into Mortgage Insurance Companies*, June 5, 1964, Washington, D.C.

[36] "Based on a statistical test, there is an absence of correlation between the number of shares held by officers and directors of an association and the percentage of eligible loans insured with the respective company. Similarly, of course, there is an absence of correlation between premiums paid and relevant shareholding." *Ibid.*

[37] Henry A. Bubb, President, Federal Savings and Loan Association, Topeka, Kansas.

access to the equity market, the new guarantor would stall at noneconomic volumes of premium written, waiting for build-up of the contingency reserve at the cost of surplus declines.

Risk Dispersion vs. Industry Concentration

At the same time that management control was used to gain access to a market and generate a powerful equity base, MGIC management worked quietly to raise entry capital requirements to close the market to "fast buck artists" and derivative guaranty speculations. For example, in Florida, in 1959-60, there was an effort to insure mortgages in the active Miami second mortgage market. This produced two company failures. There was a proposal to guaranty purchase money mortgages for sellers, with real estate brokers and attorneys serving as commission agents. MGIC management played a significant role in writing a definition of the mortgage guaranty insurance line, restricting coverage to first mortgages made by government supervised lending institutions, and at the same time raising entry capital in Florida to $500,000 in capital and $250,000 in surplus, as compared to $300,000 and $150,000 surplus for a full line property insurer.

Similar contributions to mortgage guaranty regulations were made in other states, such as Oregon and Washington. However, the most significant contributions to the future financial structure of the mortgage guaranty came as the result of a dialogue between MGIC management and the insurance department in California.

California represented the unique situation of a state seeking private mortgage guaranty as an aid to reform of the residential second mortgage practices which had led to abuses. At the same time, state officials were worried that the largest state mortgage market in the U.S. would be a Mecca for the novice mortgage guarantor, whether legitimate in intent or not.

A key feature of the resulting legislation was the provision for $1 million in capital and an additional $1 million in surplus as the minimum required for licensing. In addition, California instituted a reserve to liability ratio, which was the equivalent of .8 per cent of insured mortgage face value liability. This restriction on excess growth meant that the guarantor would actually need far more than the minimum capital required if he were to reach a scale of operations that would produce an operating profit.

Since 1961, the California standard has been the desired standard for the industry, although politically unobtainable in many areas for lack of any comparable domestic situation or for the presence of an existing guarantor without funds to meet the California standard. It may be unnecessary to observe that the standard of scale relative to insurance volume appropriate to broad risk dispersion is also appropriate to furthering industry concentration among existing guarantors.

A Contribution of Creative Regulation

Direct control of the character of modern mortgage loan insurance can be found in state laws, federal tax law, and illustrations of self-imposed standards within the industry. The Wisconsin law set the early pattern and the principal contribution of Wisconsin was the contingency reserve device. This reserve required that one-half of all earned premiums be set aside for one hundred and eighty months (15 years) to meet exceptional and cyclical losses. The guarantor could apply for permission from the insurance commissioner to use contingency reserve funds only if current incurred losses exceeded 20 per cent of earned premium.

Reserve funds were to be released to earned premium or to incurred losses on a monthly first-in, first-out basis. Dollar flows were treated on an aggregate basis, without adjustment for termination of contracts from which the insurance liability first arose. Therefore the reserve has accumulated at a compound rate long after the original exposure has been terminated or reduced through amortization.

Tax Features

The earnings, so allocated, were not included in current income tax calculations. They were regarded as a liability, similar to that of a long term disability contract loss reserve, in order to accelerate the creation of financial resources with which to survive a recession. The investment returns from these resources, however, have been left to current income, a source of investment leverage for the investor anticipating potential dividends before earnings can be released from the contingency reserve. The accounting procedure for the reserve, charged surplus for an amount equal to one-half of earned premiums, and the allocation would not appear in the usual company income and loss statement.

Earnings per share have been reported so as to include the eventual reserve allocation from surplus. Some guaranty companies create reserves on stockholder statements for the expected tax liability on earned premium within the tax sheltered contingency reserve, anticipating profit in 15 years.[38] Unless current losses and administrative expense were held within 50 per cent of earned premium, surplus would fall despite the apparent high ratio of earnings to earned premium.

State Insurance Control Features

The Wisconsin law has been modified to be similar to that of California, except for capital and surplus requirements. These were held to $900,000 and $450,000 surplus, as another domestic company already in operation in 1964 would not have otherwise qualified. The firm in question has since secured additional capital via a merger, and the statutory capital requirements should be adjusted upwards. However, this should indicate to those states without such requirements that it has been impossible to legislate such items after companies are proposed or in operation based on less stringent entry requirements.

The California Mortgage Guaranty Act in 1963[39] could be briefly described as follows:

1. The definitions restricted the mortgage guaranty business to amortized first mortgages not exceeding 90 per cent of the fair market value of the real estate of a residential building containing no more than four family units. The loan must be originated by a state or federally supervised bank, savings and loan association, or insurance company.
2. It carefully defined the liens to which a property may be subject without undermining the nature of a first mortgage.
3. It called for the creation of a contingency reserve and specifically recognized it as "established for the protection of policyholders against the effects of adverse economic cycles."
4. It defined "policyholders surplus" as the aggregate of capital surplus and contingency reserve.
5. The act put teeth in the minimum capital requirements, by calling for paid-in capital of at least one million dollars and paid-in surplus of at least another one million dollars in order to transact mortgage guaranty insurance in California. In addition, the act required a contingency

[38] The split image of a liability reserve for taxes and inclusion in policyholder surplus undermines the value of a long time reserve precedent for possible rate-making application for catastrophe insurance coverage on physical property.

[39] State of California Assembly Bill No. 1539, an act to add Sec. 119 and Chap. 2A to Pt. 6 of Div. 2 and to amend Sec. 100, 700, 911, and 984 of the Insurance Code.

reserve of 50 per cent of the earned premium to be restricted for 180 months and the commissioner "shall by regulation determine when an insurer may make withdrawal from its contingency reserve" in any given year in which actual losses exceeded expected losses.

6. The act instituted a liability ratio, which prohibited the transaction of new business whenever total liability under its aggregate insurance in force exceeded 25 times the policyholders surplus. Total liability was defined as 20 per cent of the outstanding balances of all the loans insured.

7. Dividends were restricted to the undivided profit remaining over and above the total paid-in capital, paid-in surplus and contingency reserve. In this regard as in all others, stock, mutual, or reciprocal insurers are all bound alike. Moreover, a mortgage insurer was not permitted to operate in any other insurance line in California or elsewhere.

8. Not only did the act recognize the 20 per cent of claim option of the lender, defined as 20 per cent of the balance of the loan insured, but in event that his option was exercised, the insurer's liability was not to exceed 80 per cent of the actual loss, so that the lender was at all times a co-insurer of the loan which he created, except where the guarantor took title to the property.

9. Another interesting innovation, warranted by present guarantor experience, was a charge not to insure loans "in excess of 10 per cent of policyholders surplus secured by properties in a single tract or continguous tracts:" continguous defined as "not separated by more than one-half mile."

10. Rebates and commissions to any person directly or indirectly interested in the insured lender were prohibited, and published premium charges applied to everyone.

11. Required financial statements were similar to those of Wisconsin, except the statutes specifically required a loss reserve which had three sub-accounts including: (a) Estimated losses on insured loans which had resulted in the conveyance of property which remained unsold, (b) Insured loans in the process of foreclosure, and (c) Insured loans in default for four or more months.

12. Also of interest in the act was the directive to the Commissioner to give full consideration to the desirability of high liquidity of the investment portfolio of the guarantor. Finally, there was a specific control of any advertising on the part of lenders as to their use of statements regarding insured loans.

The California Statute as summarized above or read in its full text,[40] has made a specific response to almost every recommendation of the *Alger Report.* More importantly, the California law struggled with the two most significant problems of current regulation for the rapidly expanding mortgage loan industry: the problem of maintaining reserve adequacy while rapidly expanding the insurance liability, and the problem of fair competition for a restricted market.

Control through the Market

Government favor or disfavor can also be registered through controls placed on supervised lenders. The market can be increased or decreased simply by adjusting the ratio of assets which may be invested in high ratio loans. More to the point would be statutory and audit acceptance of private guaranty loans on the same basis as FHA-VA loans and financial standards for acceptable private guarantors more detailed than those of state insurance departments.

[40] Additional interpretation and regulation effective July 15, 1962, appears in the California Administrative Code, Title 10, Chap. 5, Sub-Chap. 3, Article 10.

The Insurance Question

Demonstration of the capacity of the guarantor to meet the losses of recession real estate upheaval and the import of maximum liability-to-policyholder surplus ratios are deferred to a second article. However, implicit in statistical analysis of volumes of liability relative to aggregate resources, was an assumption that the institutional framework would produce an acceptable statistical base for quantitative analysis consistent with qualities of an insurable exposure. Such an assumption has assumed a positive answer to the question of whether the modern mortgage loan guaranty might properly be termed "insurance." Review of the economic and institutional framework of the present mortgage loan guaranty industry served to provide a basis to the answer of that question.

An insurable risk has been defined as one in which a relatively homogeneous group of factors were exposed to the same peril, suffering measurable loss as the result of accident or circumstances beyond their control, losses so interdependent that the majority of risks could not be affected at the same time, as in a catastrophe, economic or physical. Certainly, small residential lending practices since World War II have produced sufficiently homogeneous mortgage loan packages to justify statistical analysis.

While it is true that the portfolio management of the lender could affect default experience to some extent (just as housekeeping ability affects the frequency of fire loss), most losses have resulted from random domestic upset or local real estate price decline. Thus a reasonable degree of fortuity has been present. However a regional or national trend of unemployment and personal income declines due to a downturn in business activities has generally preceded rapid increases in mortgage loan delinquency, default, and foreclosure in the face of falling price levels.

Within the limits of the 20 per cent option, a fall in price level would increase the severity of loss to the guarantor at the same time frequency of loss was also increasing. Loss expectations of the guarantor therefore have business cycle magnification with catastrophic parameters, and losses attributable to the business cycle have not been the traditional providence of insurance or within the definition of the insurable risk. On the other hand, erratic catastrophe losses, such as floods, earthquakes, conflagration, and most certainly windstorm, could be handled by private insurance where premium rate, tax components, regulation and acceptance favored the use of long term reserve accumulations. For such reserves, the objective would not be actuarial solvency but rather massive "financial solidity"[41] such as associated with Lloyds of London or some American companies.

Acceptance of the latter premise would lead to a study of the rate of resource accumulation which could be expected for prescribed reserve requirements and of the consistency of underwriting standards in the accumulation of offsetting contingent liabilities. It follows that criteria for evaluation of the present institutional structure of the mortgage loan guaranty industry should measure either the degree to which any one feature strengthened policyholder surplus and reserves or avoided underwriting errors as to acceptable properties and borrowers.

Financial resources have of necessity been the product of reserve accumulation and equity investment and both of these elements have been functions of the strength of access to demand for the

[41] See footnote number 11 on Spencer Kimball. For additional discussion of the same point see Allen R. Mayerson, "An Inside Look at Insurance Regulation," *The Journal of Risk and Insurance,* Volume XXXII, No. 1, March 1965, pp. 62-64.

guaranty.[42] Reserves have depended on premium written, and capital has been invested where the opportunity was seen to secure the investment leverage and speculative underwriting gains of large amounts of premium flows. It has been suggested that the market for the guaranty is artifically defined by administrative rule and lending custom. Further it has been suggested that the most successful guarantors have grown by possessing special ties to the savings and loan market, either on a national or regional level.

These relationships would now appear to block further expansion of the market base for each guarantor. For example, associations with savings and loan factions may reduce acceptance of any one guarantor by other factions within the same line or among other institutions such as the banks. Regionalism may also discourage continued expansion into all available national markets and in several cases personality conflicts could have blocked otherwise desirable consolidations.

The Institutional Answer

It would appear that the price of a captive market has been that of a semi-captive insurer. As a result, the warning of the *Alger Report* that any ties between the insurer and the lender be prohibited, may have been unheeded to an unknown degree up to this point in guaranty development. A guarantor, working within a single region or primarily with a single type of lender, not only has lacked diversification within the credit system but has also been subject to the enthusiasms, attitudes, and unwitting excesses of that group with which he has most closely associated. The underwriting stability possible with full national business scope, the economics of scale, and the dangers of the psychology of fragmentation all argue for diversification of participation in the management of nationally oriented guarantors.

If the capacity of the reserves now required of the mortgage guarantor could be shown to be adequate to meet foreclosure frequencies appropriate to severe national recession, then the issue of whether the guaranty were truly insurance would devolve on the problem of securing average losses equal to or better than national averages. To the degree that the industry is fragmented and fails to produce a book of business for each guarantor, which reflects diversity of geographic dispersion, institutional practices, loan ratios, and seasoning of portfolios, it falls short of insurance requisites for catastrophe control.

It remains for another essay to explore techniques for measuring reserve adequacy and possibilities for further statesmanship among industry and regulatory leaders to assure full acceptance of the mortgage loan guaranty as a proper function of the insurance industry.

[42] Groups of incorporators of guarantor firms with a local or regional interest to serve have secured only minimal amounts of initial equity capital in 1957 or 1966.

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DEVELOPMENT AND STRUCTURE OF MORTGAGE LOAN GUARANTY INSURANCE IN THE UNITED STATES

JAMES GRAASKAMP

Privately financed, residential mortgage loan guaranty insurance has evolved, since 1957, from the status of an outlawed curiosity to recognition as a special class of legitimate insurance enterprise, governed by a unique and fresh sector of regulatory law. The original guaranty firm[1] controls more than $43 million in assets, has achieved a listing on the American Stock Exchange, and served as a model for an industry of at least ten firms, benefiting from total assets of $63.8 million behind insurance in force of approximately $3 billion as of January 1, 1966.[2]

In the past decade the insurance industry sought multiple-line integration of companies and contracts, struggled with the minutiae of change in the regulatory bogs, and threatened the single-line, single market company with extinction. Still, during the same period, mortgage loan guaranty insurance began to thrive by insuring only institutional lenders for loss from a single peril—mortgage default—in regard to a single property class, the owner-occupied residence of one-to-four family units. This development was achieved in cooperation with imaginative and unique regulation efforts on the part of a few state insurance commissions. In an era of rising sales cost, the guaranty firm has largely eliminated commissions of any kind, finds some marginal cost savings in superficial underwriting, and in one context, sometimes violates the principle of indemnity to achieve economy.

The mortgage loan guaranty of 1966 is a phenomenon within the insurance family

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[1] Mortgage Guaranty Insurance Company of Milwaukee, organized 1957. Data from 1965 Annual Report. MGIC coverage is available in 47 states.

[2] NAME	SYMBOL	ORG.	HOME OFFICE	INS. IN FORCE*	TOTAL ASSETS*
Mortgage Guaranty Insurance Corp.	MGIC	1957	Milwaukee, Wis.	$2,500	$43.6
Continental Mortgage Insurance after merger w. Institutional Mortgage Insurance	CMI	1961	Madison, Wis.	218	6.2
American Mortgage Insurance	AMI	1959	Raleigh, N.C.	200	4.3
First Mortgage Insurance Corp.	FMIC	1964	Greensborough, N.C.	80	2.8
Southern Mortgage Insurance Corp.	SMIC	1964	Baton Rouge, La.	38	1.4
Excel Mortgage Insurance Co.	EMIC	1963	Bettendorf, Iowa	24	2.4
First National Indemnity Co.	FNIC	1965	Houston, Tex.	14	1.1
Liberty Mortgage Insurance Co.	LMIC	1965	Springfield, Ill.	8	.6
Guaranty Insurance Trust	GIT	1965	Columbia, S.C.	—	1.1
General Mortgage Insurance Co.	GMIC	1966	Winston Salem, N.C.	—	.4
				$3,082	$63.9

* 000,000 omitted

which deserves respectful attention for creative financial and market management and for its symbiotic relationship with government regulation. The history of the mortgage loan guaranty has been highly instructive on the relationship of insurance theory to insurance practice, but as yet the theory and practice of this specialty have been largely ignored in professional insurance literature. While the essential research question for the student of mortgage loan insurance at this time is that of measuring reserve adequacy and related issues of regulation, it is first necessary to create a more general familiarity with the present guarantor program, modus operandi, and economic relationships.

Therefore this essay will serve to report the significant economic, institutional, legal, financial, and insurance aspects[3] of the private mortgage loan guaranty. A later article will treat two pivotal questions of public policy, specifically criteria for reserve adequacy and for regulatory control of an embryonic industry. This latter discussion will utilize a reserve-accumulation, simulation model program for the computer, prepared in a project with Professor Howard Thompson,[4] as well as independent study of the national mortgage loan guaranty situation. The present article will synthesize studies done in concert with Professor Richard M. Heins,[5] while serving as consultants to the original mortgage loan guaranty firm.

The Historical Context

Modern mortgage loan insurance has been defined as the indemnification of government supervised, mortgage lending institutions for the direct and consequential losses incurred by reason of non-payment of a first mortgage loan, loans generally restricted to resident-owners of single family, duplex, or up to four-unit rental buildings.[6] The coverage is classified as credit insurance, subject to the general requirements of a casualty insurance company, as well as the most severe minimum capital and reserve requirements of any recognized line of insurance. It was not ever thus, and each restraint represents experience acquired at great cost.

Geneology

The paternal ancestor of mortgage loan insurance, specifically the extinct mortgage investment guaranty, was dissected in a 1934 report, often called the *Alger Report*.[7] The Report was named after George W. Alger, who conducted the final autopsy of the industry for Governor of New York Herbert H. Lehman, (with the aid of counsel Alfred A. Cook). This history, with its catalogue of abuses and misjudgments, has been the cornerstone of all regulation, which only recently shaped the institution of mortgage loan insurance.

The statistical experience provided by the Mutual Mortgage Insurance Fund (MMIF) of the Federal Housing Administration provided data as background for the premium and reserve assumptions of mortgage loan insurance. A synopsis of the *Alger Report*, below, should provide much insight into the origins and content of current regulatory objectives in regard to mortgage loan insurance.

The business of mortgage investment guaranty was born out of wedlock with the law, in an arrangement of convenience

[3] Classification as insurance might be withheld, pending examination of its relevance to the loan guaranty.

[4] Professor Thompson is an associate professor of management in the School of Business, University of Wisconsin, specializing in computer controls and mathematical models for operations research.

[5] Professor Heins is a full professor of insurance in the School of Business, University of Wisconsin.

[6] WIS. ADM. RULES 3.09 (1).

[7] 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 State Insurance Department.

whereby a poorly worded stretch of the New York State 1885 Statutes in regard to title insurance was misinterpreted to permit the guaranty of mortgages against loss for reasons other than title defect. By 1895, at least four large mortgage banking firms allied with title companies were offering guaranties of "prompt" payment of the interest for mortgages which they had marketed to small investors. In 1904, the statutes adopted the ill-starred infant by amendment, granting title insurance firms legal standing to insure "the payment of" bonds and mortgages. The phrase was inserted in the prior title insurance law of 1892, which had been drafted to disenfranchise the guaranty by restricting the 1885 law to traditional title insurance.

Since title insurers had traditionally experienced only negligible losses, their required reserves were minimal in relation to gross liability. Entry capital was generally less than for any other insurance line. As a result, the guarantor was required to maintain no other reserve funds except the non-segregated guaranty fund to equal two-thirds of its original capital or about $67,000, as required to write title insurance. In 1911, the insurance law was further amended to permit title companies "to invest in, to purchase, and to sell with guaranty of interest and principal or with guaranty of title, such bonds and mortgages as were legal for insurance companies."

Rather than require an investment banker or trust department which wished to sell guaranty mortgages, to be licensed as an insurance company, a guarantor could be organized under either the insurance or banking laws of New York, or both. While a majority of mortgage banking firms registered under insurance laws, it was possible to organize under the banking law with only $100,000 capital. At least two New York commissioners of insurance stated publicly that the guaranty could not be considered insurance but was rather a misplaced responsibility of the Banking Commission.[8]

Following the 1911 legislation, title companies and allied trust companies began to sell guaranty mortgages for which interest was guaranteed on the date due but principal restitution was deferred 18 months after mortgagor defaulted on principal repayment. This was to allow time to foreclose and resell to generate cash for replacement of principal. Payment of defaulted taxes and foreclosure expenses were never guaranteed, but some companies found it expedient to represent that they would "attend to payment of taxes and assessments," an airy legal flourish which many investors mistook for additional guaranties.

An ill-defined legislative afterthought was added in 1913, to the effect that the power to guaranty mortgages was applicable only to those sold by the originating mortgage banker-guarantor on "improved and unencumbered single property worth 50 per cent more than the amount loaned thereon." Note that loan decisions and guaranty underwriting were all under one roof. This provision not only created unresolved debates on the definition of "improved" property, but also encouraged accommodating appraisers to win mortgage banking business by inflating appraised values in relation to actual construction cost.

A favorite guarantor security was the small denomination, participation certifi-

[8] The insurance commissioner of Wisconsin, on the other hand, one W. Stanley Smith, in 1926 recognized the guaranty of mortgages as insurance under both sub-sections (7) *surety* and (8) *title* insurance of Section 201.04 of the Wisconsin Statutes. The regulation of the guaranty business was furthered with the aid of the Securities Division which would not recognize guaranty mortgage bonds for legal investments by Wisconsin Fiduciaries unless the guarantor were in good standing with the Wisconsin Insurance Department. By 1930 none had such approval, and losses in the next five years were at a minimum for Wisconsin investors in this kind of security.

cate in the single large mortgage or large mortgage portfolio. As early as 1906, small investors purchased notes which were issued under an indenture which made the guarantor irrevocable agent in the exercise of the mortgagee's rights in his property pledge. The group series certificate purported to assign the holder an undivided interest or share in a specified amount of a bond-mortgage portfolio. The guarantor generally served the portfolio in the double role of trustee and depository, reserving the right to withdraw and substitute any mortgage in the group. These substitution privileges were intended to permit management of the portfolio and refinancing of what were short-term balloon mortgages without disrupting the continuity of the investment trust.

These powers were not seen as dangerous so long as the unblemished record of the guarantors led to tremendous expansion of the industry during the 1920's. However, the right of substitution enabled the guarantors on the brink of insolvency to loot portfolios of good mortgages for sale to insurance companies[9] in exchange for cash and sometimes weakly secured or defaulted mortgages as boot. The cash was paid as periodic interest to certificate holders who seldom knew that the actual mortgage loan, in which they held a beneficial interest, was in default or that their collateral was being diluted or liquidated.[10]

As early as 1924, a number of foresighted individuals were critical of policies and practices in the guaranty industry. However, an amendment in the New York legislature to prohibit sales of participation certificates in defaulted mortgages never came to a vote. As late as 1929, an act to impose a capital-to-liability ratio to control too rapid expansion died in legislative committees. Indeed, the legislative history of the investment guaranty was testimony to the ease with which its politically astute management achieved its legislative whims for lack of any voting block favoring certificate holders.

Autopsy

The disintegration of the real estate market from 1928-34 led to wholesale mortgage defaults which, in turn, led to intolerable cash drains on investment guaranty resources. Liquid assets were sufficient to make "on-time payments" of interest on defaulted mortgages for several years, so that many investors in guaranty securities were unaware of the status of the underlying collateral. The stripping of cash resources from the guaranty network enhanced the image of the guaranty with the small investor by 1932, whose continued purchases of such securities prolonged the agony and postponed decisive regulatory action.

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 mortgage and real estate security guaranties for 225,000 individual investors in that state alone. New Jersey, California, and Massachusetts, and a few other states had additional losses to an unknown degree.

State action was several years too late to mitigate the disaster, for it had lost control for lack of adequate, current, audited financial data. The record revealed that one career man had been responsible for the statutory examination of guarantors for 25 years, without specific instructions other than to make "a full

[9] Some of the larger insurance companies took advantage of the guarantors to dump defaulted mortgages and purchase good securities at discounted cash prices.

[10] Mortgage investment guaranty management always assumed a short depression and thereby justified any move which produced cash in the short run or fostered public confidence to save the company until prices rose magically to former levels.

and complete examination of the company."

Examinations never extended to subsidiary corporations, which were frequently used to hold foreclosed real estate (to keep it off the books of a land-poor parent company) and to hold defaulted mortgages, assets paid for by transferring stock shares or notes of the subsidiary to investment accounts of parent firms. Far worse was the practice of subsidiaries to pay interest on notes or defaulted guaranty mortgages by issuing a note to the parent company. This amount was added to receivables and to income and thence to earned surplus. Dividends were then paid stockholders from such surplus to parody the concept of "financial solidity"[11] until firms went into receivership!

Foreclosed properties were put on the books at face value of the foreclosed mortgage, plus interest, taxes, and foreclosure expenses. Thus the balance sheet surplus position of the parent firm was unaffected and disclosed nothing in the way of real estate holdings. Examiners valued mortgages and subsidiary notes on the books of a parent corporation at par, even though they were in default or in the process of foreclosure, on the assumption that properties were 50 per cent greater in value than the note foreclosed.

The examiners did not consider the guaranty of mortgages a contingent liability subject to audit or loss reserve. One company, having outstanding guaranties of $900 million, had heavy foreclosure losses, but no loss reserve or mention of the scale of guaranty exposure on the balance sheet. The absence of reserves for shrinking real estate values or increasing uncollectable receivables made analysis of income statements futile, so that the prudence of cash dividend payments to stockholders went unchallenged.

Guaranty companies were often organized within an intricate corporate network of mortgage companies, development companies, and title companies financed by trust companies, which in turn, were allied with the banks and shared the same officers, directors, and business location. Advertising of the guaranty was intentionally fuzzy as to the exact assets and to the functions of each firm in such a chain, so that many savers who purchased certificates thought their guaranties were from a bank or trust company.

Trust companies found the advertisement of their use of the guaranty useful to foster the image of conservatism, to increase the retention of service fees, and to cloak conflict of interest situations. Following the collapse of real estate prices by 1930, banks, as a matter of self interest, tried to forestall collapse of their allied guaranty firms by making large cash advances. This allowed the guaranty industry to prolong the delusion and to compound the losses of all concerned.

A Judgment

During the 1920's, the real estate aspects of the mortgage guaranty conformed to the general practice of inept appraisal, high leverage, and, in at least one case, over-certification of a mortgage portfolio. However, integrity of management did not actually break down until 1932 and 1933, when desperate executives found hope of continued liquidity in reselling at par, for cash, their own securities to the uninformed small investor, securities purchased in the money markets at great discount.

Their advertising copy men, in the tradition of the great American patent medicine man, described guaranty first mortgages, as late as 1932, as "pure gold"

[11] "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.

or "absolutely safe" and "horoscope not needed" and there was "no watching" required. An ad in 1931 urged the use of $100 group series certificate for children's savings and for Christmas gifts to grandchildren. The executive of the enterprising firm who sought the financial support of infants, admitted in the investigation that at the time he was running such an advertising campaign, he switched the investments of his own family to government bonds!

Such incidents were the acts of ordinary men in the stress and despair of extraordinary circumstances. Indeed, many of the guaranty firm leaders sincerely believed that real estate prices would return to more normal levels (i.e. 1928 levels) at any moment, if liquidation could only be forestalled until collateral resales would offset guaranty obligations.

Whatever the motivation, the investigation of such incidents created a pall of terrible scandal, an image of financial black magic and chicanery, which survived to haunt the mortgage loan insurance program of the present day, conditioning both regulation and market responses. Still, the investment guaranty was no test of the applicability of insurance principles, since none was ever employed in the line. Indeed, there is no real evidence that the guaranty would have failed if the appraisals on which they were based had been honest or competent pieces of work.

The Legacy

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, as New York chose to legislate in response to investigation of the scandal. Rather, these men recognized the basic flaw as the short term balloon mortgage itself. They 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, or brokers.

In addition, these analysts felt that there was need of a guaranty procedure which would provide accurate appraisal, personal penalties for lending malpractice, underwriting criteria, and a limited ratio of contingent liabilities to capital and surplus. Of course, it was also recommended that sizeable reserve funds be set aside in investments not subject to severe price cycles. Ironically, the *Alger Report* did not shape legislation or regulation to such an end until more than twenty years after it was written. Only since 1956 has it served as the basic primer for state insurance regulators puzzling over new proposals for mortgage loan insurance.

The Maternal Ancestor

The creation of the Federal Housing Administration (FHA)[12] in 1934, as handmaiden to lenders adopting progressive lending practices and loan forms, eventually made possible the reconsideration of mortgage loan insurance in 1957. 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

[12] For a thorough analysis of the FHA convential residential mortgage loan insurance see *Mutual Mortgage Insurance Fund* (MMIF) by Ernest M. Fisher and Chester Rapkin, 1956, Columbia University Press, New York. The insurance of MMIF is the only section of the FHA Program which is directly comparable to the sphere of interest of the privately financed mortgage loan guarantor.

was set at one-half per cent of the outstanding loan value at the beginning of each year, payable monthly over the life of the loan. In addition to the requirements of administrative reserve expense, this premium base provided for both a basic insurance reserve and in the case of MMIF for Section 203 loans, a participating reserve account for the payment of terminal dividends on an actuarial share basis to mortgagors at the time they pay off the mortgage. The actuarial formulas included detailed assumptions as to real estate price levels, annual foreclosure frequency and cyclical annual foreclosure loss severity, reflecting depression magnitude losses, and annual group loss experience. While economic events of World War II and the subsequent expansion of demand for and price level of homes, may have outdated these actuarial assumptions,[13] nevertheless the FHA formula did represent an attempt to apply insurance principles.

Initial discontent with the FHA program was not concern for costs relative to benefits, but, rather, chafing at the FHA takeover of inspection and appraisal responsibility, and administrative proscriptions on the lending operations of mortgage bankers, most particularly the savings and loan lenders.

The savings and loan industry was uncomfortable with the hidden financing charges of the discount system caused by non-market interest ceilings on FHA-VA mortgages. The appraisal and credit analysis by FHA usurped the discretion of savings and loan officers and their role as representatives of the home owner. Many lenders felt that the mutual features of the FHA Mutual Mortgage Insurance Fund were seldom understood by borrowers, increasing borrower resistance to the ½ per cent charge, after many years of prompt payment, and borrower susceptibility to overtures of other lenders to refinance at lower rates once substantial equity had accumulated.

Eventually the huge reserve accumulations and minimal losses of FHA[14] attracted the notice of New York financiers, who saw both a need for a private guarantor for savings and loan markets and a real profit potential. Such plans as they might have had (known only from trade hearsay) were quickly blighted and lost for the record by the firm New York law against such an enterprise, a law once amended with reluctance to permit the VA program within New York borders.

By 1955, the savings and loan industry was beginning to feel the pressure of growing investment reserves, attracted by increasing dividend commitments, relative to the supply of available loans at conservative loan ratios and generous interest terms. It became mandatory to lend more dollars at each opportunity to offset investable funds increasing at a rate more quickly than mortgage investment opportunities and to justify higher than average interest rates with liberal ratios to cover dividends, reserves, and overhead.

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[13] More recently, actuarial theory and insurance feasibility have taken a back seat to social theory in the administration of FHA programs which are not part of MMIF.

[14] During the year reviewed by the private guarantor book in 1955-58, the FHA had offered ten separate programs of mortgage insurance, the total income from which amounted to more than $1.2 billion by mid-1957. Seventy-three per cent came from premium and the remainder from investment and fees. Expenses were 47 per cent of earned premium, including 8 per cent for losses. The largest continuing program, and the one most analogous to private insurance, was the Mutual Mortgage Insurance Fund (MMIF). By June 30, 1957, MMIF had collected $758 million, 72 per cent from premium, 19 per cent from fees, and less than 9 per cent from other sources. Administrative expenses alone of more than $308 million amounted to 41 per cent of total income and to 56 per cent of premium income. Only $4 million had been used to meet losses on acquired property. Page 324, "The FHA Mortgage Insurance Premium—An Analysis and an Alternative," *Study of Mortgage Credit*. Subcommittee of Banking and Currency, U.S. Senate, First Session, 86th Congress, Government Printing Office, 1959, Washington, D.C.

In many cases the net income of savings and loans relative to dividend commitments left little margin for a possible increase in foreclosure losses or a reduction of investment returns through acceptance of low interest government bonds, with which FHA insured situations were indemnified.

A Broken Engagement

In 1958, the U.S. Savings and Loan league secured introduction of a proposal, specifically Title VII of the original 1958 Housing Act, to create a home mortgage loan guaranty subsidiary to the Federal Home Loan Bank, to initiate a program tailored to meet the objection to the FHA program. It was proposed that a guaranty would be provided for only the top 20 per cent of the mortgage principal and interest of a loan exposure, with coverage to last for only the first ten years. First year premiums and renewals were to be on an annual basis, or on a single premium plan, with option of cancellation and a short rate refund.

There were to be no interest ceilings, and underwriters for the guarantor were to base their decision on a review of appraisals and other credit reports by the lender, reports subject to spot checks and enforcement penalties. Banking interests secured amendments to provide a 6 per cent interest ceiling, federal appraisal, and federal property inspections of new construction. The result was that the savings and loan interests disclaimed their own bill, which failed by a small margin to become part of the 1958 bill.

Nevertheless, the new approach of the partial guaranty and an expeditious underwriting technique had been discussed frequently and enthusiastically within the savings and loan industry for several years prior to the abortive legislative putsch, so that industry leaders were favorably conditioned to such an approach. By 1957, resistance to the FHA underwriting method and interest ceiling had hardened at the same time that the need for high ratio home loan investments was apparent. The power to make such loans was becoming available in changing federal and state savings and loan investment regulations.

Then there was the subtle motivation of optimism attributable to the resurging confidence of the savings and loan industry, accompanying its powerful expansion within the consumer-savings, home-lending market, or perhaps to the prevalent attitude of the Eisenhower era that "big business" could do almost anything better than "big government." For whatever reason, people were ready to listen to a proposal for private mortgage loan insurance and to set aside the experience of mortgage investment guaranties as a memory of mortgage banking adolescence.

Private Mortgage Loan Guaranty Plan

The creation of a private mortgage loan guarantor as an operating reality can be attributed in large part to the inventiveness and drive of a Wisconsin real estate attorney, Max Karl,[15] experienced with the strong Milwaukee savings and loan fraternity. After a year of study, he submitted his proposal for a guaranty plan to the Wisconsin Insurance Department in late 1956. He found a rationale in the FHA experience, the activities of the Savings and Loan League on behalf of Title VII, and miscellaneous actuarial projections. However reluctant the Wisconsin State Insurance Department was to risk its reputation on such an unproven concept (reflecting on the 1934 scandals), it was not unmindful of the potential premium tax income which could result from such a successful firm. Also there was professional curiosity among its able technicians as to the feasibility of such programs.

[15] Mr. Karl continues as the President of MGIC and leading statesman of the fledgling industry.

Responsive to the impressive FHA record and the limited endorsement of the *Alger Report*, the insurance department chose to introduce the unprecedented insurance operation within the controls of a new section of the administrative code.[16] This could be modified quickly to meet any situation, simply by announcing a public hearing and then a ruling by the Commissioner. A license was issued upon an interpretation of the title insurance enabling statute[17] by the Attorney General. As this classification was objectionable to other state insurance departments (where capital requirements remained at pre-1929 levels) Wisconsin Insurance Statutes were amended to include specifically the guaranty as a branch of credit insurance.[18]

In 1965, Wisconsin Law was amended with the encouragement of state-based guaranty firms to create a separate line of mortgage loan guaranty insurance with its own capital requirements.[19] The exchange between the sponsors of private mortgage insurance and state regulation agencies has been essentially a creative and refreshing interlude in regulatory-industry relations.

Underwriting Plan

The underwriting program for mortgage loan guaranty insurance has three basic elements: (1) selective qualification of eligible lenders, (2) selective review of basic information submitted with an application for guaranty insurance for individual loans, (3) constant spot checks of local economic factors, lender appraisals, and credit reports. A master policy is issued to qualified lenders, specifically those who have state or federal supervision, regular daily business hours, a certain minimum size, demonstrated management ability, and appraisal sophistication.

Approved lenders may then submit individual loans to be insured or rejected on a case basis, with a certificate of commitment or of insurance issued for each qualified loan. For each loan, the lender submits a copy of the loan application, the proposed terms, a credit report, supplemental information on borrower income and fixed expenses and an appraisal of the real estate by the lender.

With the aid of a few key ratios, caveats, and current local market surveys, an underwriter will accept or reject the submission by return mail.[20] With the aid of local independent appraisers, appraisals have been spot checked and credit reporting agencies tested as to reliability, initially for one out of every five accepted applications although presently spot checks would be made on a ratio approximating one to fifteen. Lenders who appear to misrepresent properties are dropped from further participation.[21] In addition, the company has done regional and municipal economic studies which may result in certain communities falling out of bounds for coverage.

This relatively simple underwriting network, involving the home office and in some cases the regional underwriting office, reflected a basic assumption of the private guarantor, derivative of FHA experience. If the FHA record were studied for the conventional loan with 10 per cent or more downpayment and for programs without intent to provide ownership for special groups, then it would be argued the marginal cost of assuming the total

[16] WIS. ADM. RULES 3.09.

[17] WIS. STATS. 201.04 (8).

[18] WIS. STATS. 201.04 (9).

[19] WIS. STATS. 201.04 (19).

[20] Long delays on committments were a constant irritation for those using the FHA program in the mid-1950's, as Congress failed to appropriate sufficient funds for adequate staffing.

[21] In several cases, where savings and loan institutions in Chicago were in the process of disintegration due to fraudulent operations, MGIC had suspicions, from spot checks, a full year before these institutions were closed by federal auditors.

appraisal, inspection, and credit analysis burden to standardize and control the mortgage loan process was not justified[22] by a corresponding marginal saving in terms of foreclosure loss avoided.

The private guarantor assumed that his administrative savings would be far greater than the cost of his underwriting errors, thereby justifying issuance of a guaranty for the high ratio loan at a cost significantly lower than comparable FHA coverage. The private guarantor has generally charged ½ per cent of the initial loan balance for the first year, and ¼ per cent of the opening loan balance for each of the next nine years, should the lender care to renew each year. A single premium plan has also been available from the outset for 2 per cent of the initial mortgage balance, a charge which would be included in closing costs. This charge could be refunded should the lender cancel on a special short range basis. In addition, an appraisal fee of $25 has been charged for loan applications involving an 80 per cent loan to value ratio, or better.

The maximum acceptable loan would be 90 per cent, although subordinated or collateralized debt would be permitted up to 95 per cent of appraised value, so long as debt service, disposable income and other factors remain within the single mortgage standard. A single premium renewal contract covering the eleventh through fifteenth years was contemplated initially, but now ten years later, the termination rate on coverage has been such to suggest elimination of any effective demand for the extension period coverage.

The Contract

Certainly the contract represented a new standard for clarity and brevity for agreements among financial institutions, with about 20 clauses and a short rate table spaced over four pages.[23] Coverage for the lender contemplated an amount determined as: (1) interest on the mortgage balance until title is transfered to guarantor (excluding penalty interest), (2) real estate taxes, insurance premiums and maintenance expenses necessary to carry the property until clear title can be transferred to the guarantor, (3) court costs of foreclosure, (4) attorney fees not to exceed 3 per cent of the balance due, and (5) in lieu of the above a reservation of the right to pay only 20 per cent of the claim as determined above and a waiver of the claim to the real estate by the guarantor.

This coverage would be non-cancellable by the guarantor for ten years, renewable each year at option of the lender. The lender would be expected to notify the guarantor of a delinquency within four months of the onset. Foreclosure action need not start until the total balance in default were equal to nine monthly payments, thereby reserving considerable discretion to the lender.

Letters of commitment for payment financing of new construction have long been available and open-ending accomplished following a review by the guarantor underwriter.[24] For the benefit of the borrower, expected to pay the premium, state statutes generally have required that the policy relieve owner-residents from any deficiency judgment action by the guarantor following foreclosure and resale.[25]

[22] It must be remembered original guaranty plans were based on the FHA operating record through 1956, before the impact of very low downpayment loans caused foreclosure frequencies to rise significantly.

[23] The typical contract in use is substantially the same as drafted by Max Karl in 1957, save for the 20 per cent option, which was introduced in late 1958.

[24] In some cases lenders on small rental buildings have asked to open for principal in default and have cancelled in pique at the turndown.

[25] The lender may retain the right to a deficiency judgment in states where the waiver is not required by law but only as a result of a standard guaranty contract. Such an oversight would appear unfair to the borrower.

Marketing

At the very beginning, the guaranty was sold through district agents with sub-agents who serviced one or more lenders, predominantly savings and loan lenders, as other lending institutions were subject to conservative investment regulation, conservative directorship, or loan correspondent contracts with sufficient geographical dispersion to "self-insure." However, it became possible to distribute master policies through salaried district representatives and most sales are now made in that manner.[26]

At first, many savings and loans were reluctant to make any loan in excess of a 70 per cent ratio, with or without a guaranty. The marketing problem was to educate the lenders to standard appraisal, credit, and loan committee standards appropriate to the low down-payment home. Often the guaranty served as an aid to the young, aggressive loan officer in his effort to secure more liberal lending standards from an older, conservative board of directors.

As saving and loan lenders gained experience and confidence, they began to assume the risk of the high-ratio, quality loan and simply to insure the more marginal situations. The guarantor began to receive a smaller proportion of a lender's mortgage volume, a higher average loan ratio, and more marginal credit reports. Lenders often used the rejection by the guarantor underwriter as a polite way to say "no." In short the marketing question has become primarily concerned with avoiding adverse selection by qualified lenders. Not only have lenders tended to reduce offerings to the guarantors but have tended to cancel coverage at an earlier date.

When the only high-ratio loans permissible to a supervised lender were FHA-VA loans, the lender was required to submit all such proposals to FHA. Today the lender may choose among FHA, VA, the private guarantor, or assumption of risk alternatives. Worse, the lender could submit the loan to several guarantors which might compete for a restricted market by relaxing underwriting standards.[27] Potential for adverse selection has remained as one of the major problems for the guarantor and the regulator.

These marketing trends might cause the guarantor to change to a five year single premium non-cancellable plan, in addition to adopting underwriting rules requiring approved lenders to submit a certain minimum number of acceptable loans each year. A large number of lenders have carried the master policy of one or more companies, at no cost to the lender, without using the service at all or simply as a third party, negative decision-making device.

Another aspect of marketing has been that of encouraging regulatory agencies to liberalize loan ratio requirements for credit unions, pension funds, trusts, and banks, so that more institutions would consider high ratio loans with a private guaranty. In 1954, national banks received permission to make a few 90 per cent ratio home loans, if insured by a public or private guarantor for at least the top 20 per cent of the loan. The advent of tight mortgage money and higher than average commercial and consumer loan activity has given banks little cause to use this privilege. Market development includes legislative reform of acceptable loan insurance for fiduciaries in any given state, such as this suggested clause from a model legislation format circulated by the management of MGIC:

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[26] Some states prohibit payment of a commission or placement of an agent within lending organizations.

[27] The new company might hope to win friends by accepting loans others might refuse, anticipating that, with time, reciprocity and inflation might offset losses in future higher premium volumes.

> Investors in residential mortgage loans shall be exempt from any statutory loan to value ratio limitations provided the loans are guaranteed by the Veterans Administration, or insured against loss by the Federal Housing Administration or *any mortgage guaranty insurance company licensed to transact business under the insurance laws of this state.* (Author's emphasis)

Where lending controls have not been relaxed, new financial institutions have been created. For example, in Canada insurance companies have been limited to 67 per cent loans. A mortgage banking firm, encouraged by MGIC, developed a "piggy-back package" of a 67 per cent first mortgage note for the insurance company and a 23 per cent ratio note insured by MGIC for the investment company. Both notes were to be secured by a first mortgage giving liquidating priority to the insurance company portion.

An unfortunate aspect of an increase in market due to regulatory action has been the rapid increase in the use of private mortgage guaranty insurance in the South, to avoid the open occupancy requirements of FHA programs. Should federal proscription of discrimination be extended to loan policies for federally chartered lenders, the market for the guaranty with government supervised lenders would probably evaporate as various private mortgage banking subterfuges were initiated.

The potential market for the use of private loan insurance has been slotted between regulatory restriction on high ratio loans, the degree of resistance to current government sponsored programs, and the supply of money in excess of the demand for low ratio loans. This is an artificial market, dependent on administration rule, custom, and shifting investor mood.

Perhaps the major marketing success to date has been the ability to convince the savings and loan industry that a firm, or the guaranty industry itself, can provide security for the lender due to the dispersion of risk by the guarantor, with only 4 per cent reserves, when the average savings and loan lender has uncommitted surplus reserves equal to 6.6 per cent of outstanding mortgage liabilities.[28]

Loss Adjustment Methods

A loss claim would involve both the accounting problems of creating proper reserves and the operational problems of correcting defaults, acquiring foreclosure property, and disposing of property acquired. Within the latter set of related problems, the MGIC management finds a letter or a personal visit has been sufficient to motivate the borrower to maintain his payments in more than 50 per cent of reported delinquencies. Delinquencies should be, in part, a matter for control by skilled portfolio management by the lender. More serious defaults have often been settled by effecting resale or voluntary transfer to the lender. The remainder, perhaps 6/10 of 1 per cent of loan volume in force and only half of reported delinquencies, have entered foreclosure, a process ranging from 1 to 18 months in the various states.

Initially the company expected to take title to most property and reserve the 20 per cent of claim limitation for use only in times of recession, the company preferring partial liquidation of assets to a transfer of assets into non-liquid real estate. However the cost of managing and negotiating sales in various parts of the country was not always justified in terms of the net reduction in loss[29] relative to cash payment of the 20 per cent award. As the number of properties within

[28] *Fact Book*, 1965, U.S. Savings and Loan League, p. 90.

[29] The net at risk to the mortgagor is the difference between price indemnity of the lender under the contract and net proceeds on sale of acquired property by the guarantor. Changing real estate price levels theoretically require the guarantor to time sales to seasonal and cyclical price peaks for each community.

the claim process grew, the company found it expedient and economical to pay 20 per cent of the claim and to allow the local lender to resell the property for the remainder of his cash investment. While such a step might leave the lender without full indemnity for his own appraisal error, in most cases the lender has been able to dispose of the property for more than the 80 per cent balance due. The result is that a lender may profit to a small degree on the foreclosure situation, bending the principle of indemnity.

Such an opportunity has been proven preferable to the FHA payment in low interest, federal funds with a maturity date parallel to the defaulted mortgage term. In many states such a practice could violate the principle of indemnity. In some states, such as California, the law has prohibited the guarantor from paying more than 80 per cent of the net loss to the lender on resale, not to exceed 20 per cent of the full claim, making the co-insurance feature applicable in all cases. Partly as a result of the decision to pay the 20 per cent option, the severity of loss has risen from a negative figure in 1957 to an average of $2,600 per case[30] in 1965. Administrative costs have been avoided and the value of property retained has involved a smaller proportion of assets than was first anticipated, increasing investable funds and investment income.

From the accounting viewpoint, loss reserves would best be divided into three sub-accounts including:[31] (1) Estimated losses on insured loans which have resulted in the conveyance of property which remains unsold, (2) Insured loans in the process of foreclosure, and (3) Insured loans in default for four or more months.

In each case the loss would reflect the difference between a current independent appraisal of the property, adjusted for net resale proceeds after commissions, taxes, and maintenance and the estimated claim to be made if and when foreclosure were completed. The frequency of loss has fallen, while the severity per loss has been rising as a result of changes in underwriting policies. Early in its career, MGIC made commitments on several subdivisions and apartment projects which proved unmarketable, and heavy loss reserve allocations were only avoided when key stockholders took over the projects from insolvent contractors.

Largely as a result of this experience, some states prohibited the issuance of guaranty policies in excess of 10 per cent of surplus for a single tract or contiguous areas "not separated by more than one-half mile." Intra-company studies indicate insurance commitments generally ripen into claims within four years and are generally the product of a faulty appraisal, an incomplete credit report, or a reduction of employment by a major local employer.

Management Resources

Key management personnel to staff the new guaranty insurance industry have largely been drawn from the law, appraisal, government regulatory agencies, and real estate trade organizations. In addition to the lawyers, influential leaders of the industry include two former state insurance commissioners, several state FHA directors, several nationally recognized appraisers, well known local realtors or loan officers, and several former regional directors of mortgage lending trade associations.

It is perhaps premature to judge management effectiveness, as it has yet to be tested by the pressures of prolonged recession, broad scale competition, or reliable industry expense ratios. However, the evolution of the financial structure of the

[30] Based on review of only three company loss reports for 1965.

[31] Required by statute only for companies choosing to be licensed in California.

early guarantors does give some indication of the creativity of early management and of current management concern for adequate regulation to prevent the failure of an under-capitalized, over-promoted, guaranty firm, to the discredit of all mortgage guaranty insurance.

Development of Guarantor Financial Structure

Those most familiar with the financial dilemma of a mortgage guarantor, have advocated minimum capital for entry into the line of $1 million of capital and $1 million of paid-in surplus,[32] derived from a single class of common stock of one-line company. In part, these standards reflected the desire of many regulators to advance all insurance company minimum capital requirements to reflect current dollar values, but in large part these standards were suggested by the financial path of the first guarantor, MGIC. A brief biography of the financial moves of this pioneer has been quite instructive for students of insurance finance in general and some modern day regulators in particular.

Financial Biography

Licensed in mid-February of 1957, MGIC began with $262,500.00, only $12,500.00 more capital than the minimum required, capital raised in bits and pieces from a small coterie of Milwaukee real estate investors. To avoid the inroads on surplus, an expected element of all insurance start-up and acquisition costs, MGIC was actually two corporations, a licensed insurance company and an independent marketing corporation. This separate corporation, Guaranty Insurance Agency, Inc., was capitalized by requiring investors to purchase one Agency share with each four shares of MGIC stock.

By contract, Agency organized all sales functions for MGIC, for which it received commissions on a premium earned base rather than a premium written base. In addition it received required appraisal fees and purchased necessary appraisal spot checks. Since Agency paid its sales representatives on the basis of premium written, the difference between receipts and disbursements was financed from bank loans and a surplus deficit. Since the ownership of Agency by MGIC shareholders removed Agency from regulation by the insurance department as a subsidiary, the bank financing of acquistion costs of new business did not appear on MGIC statements.

In Florida a new, non-domestic insurance corporation must have operated successfully for three years outside of Florida before becoming eligible for licensing in that state; domestic subsidiaries of an ineligible foreign insurer were also excluded. Agency, however, was not an insurance corporation under Florida law and so it organized an MGIC of Florida, capturing an important residential mortgage market. MGIC of Florida was quickly liquidated by merger into the parent MGIC organization as soon as MGIC became approved in Florida in the spring of 1960.

Agency itself was liquidated in October of 1960, reflecting a change from a commission schedule to direct salaried representation, a stronger MGIC surplus position, and a tacit recognition of the irritation of regulators with regard to Agency as a satellite (if not a subsidiary) of MGIC. At this time MGIC created a wholly owned subsidiary of Mortgage Finance Corporation (MFC). It was intended that MFC provide the real estate appraisals and economic analyses funded by the appraisal fee which accompanied each application for a high ratio loan.[33]

[32] These are the California requirements; typical other state requirements are Wisconsin, $900,000 capital $450,000 paid-in surplus; Florida $500,000 capital $250,000 paid-in surplus.

[33] These fees, which at that time were $20 for each application, represented a major source

If these fees were paid directly to MGIC, there was the chance of classification as similar to a mutual membership fee or underwriting fee, which Commissioners in Wisconsin and elsewhere regarded as additional first year premium, subject to monthly reserve allocation to income, thereby postponing their impact on surplus. In addition, it was expected that MFC would acquire at cost, property to which title had been taken by MGIC due to full payment of a guaranty claim. MFC could operate the property as a rental unit, providing depreciation tax cover for appraisal fee income, or sell the property under land contract, recovering the dollar investment in the property over the long term. MFC expected to finance the property holding operation with lending agencies in the locale of each property, while MGIC would experience no book loss on claims so handled.

Wisconsin insurance audit procedures treated MGIC holdings of MFC stock as an inadmissible asset, so that real estate held by MFC and attendant mortgage borrowing would not appear on a consolidated MGIC balance sheet. MFC was motivated primarily by tax considerations and the need to tap mortgage funds to maintain property holding inventories. It was easily identified with the property holding shadows of the mortgage investment scheme of the 1930's, an unfortunate connotation in light of the Alger Report warning against subsidiaries of any kind. Apparently state regulators made their feelings known and MFC was dissolved. Appraisal fees were treated as premium income by 1963 and company loss adjustment policies were altered to favor payment of claims in cash under the 20 per cent option.

The concentration of all functions within MGIC paralleled a steady expansion of its equity base through sale of common stock. The original no par value shares were successively transformed, through stock splits, to $80 par, $10 par, and $1 par shares, which served both the sale of stock and the need for additional surplus, drained by continual expansion. Sale of stock was at first limited to Wisconsin, underwritten entirely by MGIC, and at one point a technical violation of federal security laws required a tender to repurchase all outstanding stock; no tenders resulted.

By 1960, there was an over-the-counter market for MGIC shares in the Milwaukee area, but shares were scarce and an understanding of MGIC even more rare so that prices fluctuated wildly, with a few sales recorded at $50 per share for stock that might have cost the early investor about $1.60. A New York investment banking firm was called on to manage and underwrite an ambitious equity capital program in 1961, at which time about $5.5 million in equity was generated through sale of 236,000 shares at a price of $27 per share. Another stock sale was accomplished in 1963 at $30 per share for an additional $6 million of capital. The surprising capital appreciation enjoyed by early investors has been a prime incentive for the organization of imitators of MGIC in various sections of the country.

Oligopsony

The first guaranty firms found a market for stock shares among people associated with the savings and loan industry and in 1964 the Home Loan Bank conducted an investigation[34] of the relationship of

of revenue when it is remembered that applications reached 10,000, 15,000, and more during these years, most of which required payment of the fee.

[34] MGIC officers had once facilitated a bank loan to one Robert Baker, an administrative staff man in the U.S. Senate, with which Mr. Baker purchased shares of MGIC at the then registered stock price. Subsequently stock splits and market action produced a profit for Mr. Baker which was a subject of inquiry as part of a broader investigation, which in time precipitated some parallel inquiries by other federal agencies of firms

the use of the guaranty to the stock ownership position of lending officers.[35] The investigating board concluded there was no "statistical proof"[36] of any conflict of interest between stock ownership in a guarantor and decisions by loan officers to require the use of such insurance in any given loan situation.

However, the most significant element in the financial structure was not the skillful expansion of common stock ownership, but rather the daring expansion of the guarantor market and political constituency in exchange for a degree of financial control. In 1958, when the plan to be operated by the Home Loan Bank was scuttled in Congress, MGIC was an operating fact in at least eight states, offering an insurance plan identical to that proposed for the Home Loan Bank, (save for the $20 million of capital).

On the initiative of the Milwaukee group, MGIC expanded its board of directors to twelve and seated seven former presidents of the U.S. Savings and Loan League, including Henry A. Bubb as Chairman of the Board,[37] the leading Washington exponent of the Home Loan Bank guaranty proposal. Representing all sections of the country and well-known to all major savings and loan institutions, the directors gave the firm national visibility, a preferred market position, and an access to the major capital money markets.

This ploy represented one of the clearest demonstrations of current insurance financial strategy, specifically that corporate control rests with those who have market access and not with those who own the largest number of shares. Growth for any new insurance company has been best achieved by means of a captive market or captive sales force. Despite these indirect ties to the most effective political force representing the savings and loans, the League was careful to disclaim any endorsement of MGIC and forbade its employees to have any financial interest or other tie which might be construed as tacit approval.

Contact was made with the savings and loans on a large scale, at the same time that their lending restrictions were liberalized to permit successively higher loan ratios, reaching 90 per cent, 30 year term, $26,500 limitations by 1959. Therefore, just as MGIC was receiving an infusion of capital, an image of established respectability, and a more favorable reception by state insurance regulators, the volume of mortgages made at terms appropriate for the use of guaranty insurance mushroomed.

Timing was perfect, and insurance written approached $2 billion before the end of 1964. As will be shown, success engendered a new threat to the industry when California imposed a maximum liability-to-policyholders surplus ratio for companies licensed in that state. If certificate termination had not exceeded expectations, total insured mortgage volume for MGIC would have reached its ceiling and forced premature additional equity financing.

Unless stock offerings were staged to await increasing stock prices, growth would require new equity, diluting existing equity interests in the contingency reserve and undermining the price per share and absorption of stock offerings. Without

known to have been acquainted with Mr. Baker. There has been no evidence that Mr. Baker was able to reciprocate the favor for any mortgage guarantor, and newspaper reports that his interest secured income tax exemption of contingency reserves is in direct conflict with facts and dates established by records available to the author.

[35] *Statement of the Federal Home Loan Bank Board on the Inquiry into Mortgage Insurance Companies*, June 5, 1964, Washington, D.C.

[36] "Based on a statistical test, there is an absence of correlation between the number of shares held by officers and directors of an association and the percentage of eligible loans insured with the respective company. Similarly, of course, there is an absence of correlation between premiums paid and relevant shareholding." *Ibid.*

[37] Henry A. Bubb, President, Federal Savings and Loan Association, Topeka, Kansas.

access to the equity market, the new guarantor would stall at noneconomic volumes of premium written, waiting for build-up of the contingency reserve at the cost of surplus declines.

Risk Dispersion vs. Industry Concentration

At the same time that management control was used to gain access to a market and generate a powerful equity base, MGIC management worked quietly to raise entry capital requirements to close the market to "fast buck artists" and derivative guaranty speculations. For example, in Florida, in 1959-60, there was an effort to insure mortgages in the active Miami second mortgage market. This produced two company failures. There was a proposal to guaranty purchase money mortgages for sellers, with real estate brokers and attorneys serving as commission agents. MGIC management played a significant role in writing a definition of the mortgage guaranty insurance line, restricting coverage to first mortgages made by government supervised lending institutions, and at the same time raising entry capital in Florida to $500,000 in capital and $250,000 in surplus, as compared to $300,000 and $150,000 surplus for a full line property insurer.

Similar contributions to mortgage guaranty regulations were made in other states, such as Oregon and Washington. However, the most significant contributions to the future financial structure of the mortgage guaranty came as the result of a dialogue between MGIC management and the insurance department in California.

California represented the unique situation of a state seeking private mortgage guaranty as an aid to reform of the residential second mortgage practices which had led to abuses. At the same time, state officials were worried that the largest state mortgage market in the U.S. would be a Mecca for the novice mortgage guarantor, whether legitimate in intent or not.

A key feature of the resulting legislation was the provision for $1 million in capital and an additional $1 million in surplus as the minimum required for licensing. In addition, California instituted a reserve to liability ratio, which was the equivalent of .8 per cent of insured mortgage face value liability. This restriction on excess growth meant that the guarantor would actually need far more than the minimum capital required if he were to reach a scale of operations that would produce an operating profit.

Since 1961, the California standard has been the desired standard for the industry, although politically unobtainable in many areas for lack of any comparable domestic situation or for the presence of an existing guarantor without funds to meet the California standard. It may be unnecessary to observe that the standard of scale relative to insurance volume appropriate to broad risk dispersion is also appropriate to furthering industry concentration among existing guarantors.

A Contribution of Creative Regulation

Direct control of the character of modern mortgage loan insurance can be found in state laws, federal tax law, and illustrations of self-imposed standards within the industry. The Wisconsin law set the early pattern and the principal contribution of Wisconsin was the contingency reserve device. This reserve required that one-half of all earned premiums be set aside for one hundred and eighty months (15 years) to meet exceptional and cyclical losses. The guarantor could apply for permission from the insurance commissioner to use contingency reserve funds only if current incurred losses exceeded 20 per cent of earned premium.

Reserve funds were to be released to earned premium or to incurred losses on a monthly first-in, first-out basis. Dollar flows were treated on an aggregate basis, without adjustment for termination of contracts from which the insurance liability first arose. Therefore the reserve has accumulated at a compound rate long after the original exposure has been terminated or reduced through amortization.

Tax Features

The earnings, so allocated, were not included in current income tax calculations. They were regarded as a liability, similar to that of a long term disability contract loss reserve, in order to accelerate the creation of financial resources with which to survive a recession. The investment returns from these resources, however, have been left to current income, a source of investment leverage for the investor anticipating potential dividends before earnings can be released from the contingency reserve. The accounting procedure for the reserve, charged surplus for an amount equal to one-half of earned premiums, and the allocation would not appear in the usual company income and loss statement.

Earnings per share have been reported so as to include the eventual reserve allocation from surplus. Some guaranty companies create reserves on stockholder statements for the expected tax liability on earned premium within the tax sheltered contingency reserve, anticipating profit in 15 years.[38] Unless current losses and administrative expense were held within 50 per cent of earned premium, surplus would fall despite the apparent high ratio of earnings to earned premium.

State Insurance Control Features

The Wisconsin law has been modified to be similar to that of California, except for capital and surplus requirements. These were held to $900,000 and $450,000 surplus, as another domestic company already in operation in 1964 would not have otherwise qualified. The firm in question has since secured additional capital via a merger, and the statutory capital requirements should be adjusted upwards. However, this should indicate to those states without such requirements that it has been impossible to legislate such items after companies are proposed or in operation based on less stringent entry requirements.

The California Mortgage Guaranty Act in 1963[39] could be briefly described as follows:

1. The definitions restricted the mortgage guaranty business to amortized first mortgages not exceeding 90 per cent of the fair market value of the real estate of a residential building containing no more than four family units. The loan must be originated by a state or federally supervised bank, savings and loan association, or insurance company.
2. It carefully defined the liens to which a property may be subject without undermining the nature of a first mortgage.
3. It called for the creation of a contingency reserve and specifically recognized it as "established for the protection of policyholders against the effects of adverse economic cycles."
4. It defined "policyholders surplus" as the aggregate of capital surplus and contingency reserve.
5. The act put teeth in the minimum capital requirements, by calling for paid-in capital of at least one million dollars and paid-in surplus of at least another one million dollars in order to transact mortgage guaranty insurance in California. In addition, the act required a contingency

[38] The split image of a liability reserve for taxes and inclusion in policyholder surplus undermines the value of a long time reserve precedent for possible rate-making application for catastrophe insurance coverage on physical property.

[39] State of California Assembly Bill No. 1539, an act to add Sec. 119 and Chap. 2A to Pt. 6 of Div. 2 and to amend Sec. 100, 700, 911, and 984 of the Insurance Code.

reserve of 50 per cent of the earned premium to be restricted for 180 months and the commissioner "shall by regulation determine when an insurer may make withdrawal from its contingency reserve" in any given year in which actual losses exceeded expected losses.

6. The act instituted a liability ratio, which prohibited the transaction of new business whenever total liability under its aggregate insurance in force exceeded 25 times the policyholders surplus. Total liability was defined as 20 per cent of the outstanding balances of all the loans insured.

7. Dividends were restricted to the undivided profit remaining over and above the total paid-in capital, paid-in surplus and contingency reserve. In this regard as in all others, stock, mutual, or reciprocal insurers are all bound alike. Moreover, a mortgage insurer was not permitted to operate in any other insurance line in California or elsewhere.

8. Not only did the act recognize the 20 per cent of claim option of the lender, defined as 20 per cent of the balance of the loan insured, but in event that his option was exercised, the insurer's liability was not to exceed 80 per cent of the actual loss, so that the lender was at all times a co-insurer of the loan which he created, except where the guarantor took title to the property.

9. Another interesting innovation, warranted by present guarantor experience, was a charge not to insure loans "in excess of 10 per cent of policyholders surplus secured by properties in a single tract or contiguous tracts:" contiguous defined as "not separated by more than one-half mile."

10. Rebates and commissions to any person directly or indirectly interested in the insured lender were prohibited, and published premium charges applied to everyone.

11. Required financial statements were similar to those of Wisconsin, except the statutes specifically required a loss reserve which had three sub-accounts including: (a) Estimated losses on insured loans which had resulted in the conveyance of property which remained unsold, (b) Insured loans in the process of foreclosure, and (c) Insured loans in default for four or more months.

12. Also of interest in the act was the directive to the Commissioner to give full consideration to the desirability of high liquidity of the investment portfolio of the guarantor. Finally, there was a specific control of any advertising on the part of lenders as to their use of statements regarding insured loans.

The California Statute as summarized above or read in its full text,[40] has made a specific response to almost every recommendation of the *Alger Report*. More importantly, the California law struggled with the two most significant problems of current regulation for the rapidly expanding mortgage loan industry: the problem of maintaining reserve adequacy while rapidly expanding the insurance liability, and the problem of fair competition for a restricted market.

Control through the Market

Government favor or disfavor can also be registered through controls placed on supervised lenders. The market can be increased or decreased simply by adjusting the ratio of assets which may be invested in high ratio loans. More to the point would be statutory and audit acceptance of private guaranty loans on the same basis as FHA-VA loans and financial standards for acceptable private guarantors more detailed than those of state insurance departments.

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[40] Additional interpretation and regulation effective July 15, 1962, appears in the California Administrative Code, Title 10, Chap. 5, Sub-Chap. 3, Article 10.

The Insurance Question

Demonstration of the capacity of the guarantor to meet the losses of recession real estate upheaval and the import of maximum liability-to-policyholder surplus ratios are deferred to a second article. However, implicit in statistical analysis of volumes of liability relative to aggregate resources, was an assumption that the institutional framework would produce an acceptable statistical base for quantitative analysis consistent with qualities of an insurable exposure. Such an assumption has assumed a positive answer to the question of whether the modern mortgage loan guaranty might properly be termed "insurance." Review of the economic and institutional framework of the present mortgage loan guaranty industry served to provide a basis to the answer of that question.

An insurable risk has been defined as one in which a relatively homogeneous group of factors were exposed to the same peril, suffering measurable loss as the result of accident or circumstances beyond their control, losses so interdependent that the majority of risks could not be affected at the same time, as in a catastrophe, economic or physical. Certainly, small residential lending practices since World War II have produced sufficiently homogeneous mortgage loan packages to justify statistical analysis.

While it is true that the portfolio management of the lender could affect default experience to some extent (just as housekeeping ability affects the frequency of fire loss), most losses have resulted from random domestic upset or local real estate price decline. Thus a reasonable degree of fortuity has been present. However a regional or national trend of unemployment and personal income declines due to a downturn in business activities has generally preceded rapid increases in mortgage loan delinquency, default, and foreclosure in the face of falling price levels.

Within the limits of the 20 per cent option, a fall in price level would increase the severity of loss to the guarantor at the same time frequency of loss was also increasing. Loss expectations of the guarantor therefore have business cycle magnification with catastrophic parameters, and losses attributable to the business cycle have not been the traditional providence of insurance or within the definition of the insurable risk. On the other hand, erratic catastrophe losses, such as floods, earthquakes, conflagration, and most certainly windstorm, could be handled by private insurance where premium rate, tax components, regulation and acceptance favored the use of long term reserve accumulations. For such reserves, the objective would not be actuarial solvency but rather massive "financial solidity"[41] such as associated with Lloyds of London or some American companies.

Acceptance of the latter premise would lead to a study of the rate of resource accumulation which could be expected for prescribed reserve requirements and of the consistency of underwriting standards in the accumulation of offsetting contingent liabilities. It follows that criteria for evaluation of the present institutional structure of the mortgage loan guaranty industry should measure either the degree to which any one feature strengthened policyholder surplus and reserves or avoided underwriting errors as to acceptable properties and borrowers.

Financial resources have of necessity been the product of reserve accumulation and equity investment and both of these elements have been functions of the strength of access to demand for the

[41] See footnote number 11 on Spencer Kimball. For additional discussion of the same point see Allen R. Mayerson, "An Inside Look at Insurance Regulation," *The Journal of Risk and Insurance,* Volume XXXII, No. 1, March 1965, pp. 62-64.

guaranty.[42] Reserves have depended on premium written, and capital has been invested where the opportunity was seen to secure the investment leverage and speculative underwriting gains of large amounts of premium flows. It has been suggested that the market for the guaranty is artifically defined by administrative rule and lending custom. Further it has been suggested that the most successful guarantors have grown by possessing special ties to the savings and loan market, either on a national or regional level.

These relationships would now appear to block further expansion of the market base for each guarantor. For example, associations with savings and loan factions may reduce acceptance of any one guarantor by other factions within the same line or among other institutions such as the banks. Regionalism may also discourage continued expansion into all available national markets and in several cases personality conflicts could have blocked otherwise desirable consolidations.

The Institutional Answer

It would appear that the price of a captive market has been that of a semi-captive insurer. As a result, the warning of the *Alger Report* that any ties between the insurer and the lender be prohibited, may have been unheeded to an unknown degree up to this point in guaranty development. A guarantor, working within a single region or primarily with a single type of lender, not only has lacked diversification within the credit system but has also been subject to the enthusiasms, attitudes, and unwitting excesses of that group with which he has most closely associated. The underwriting stability possible with full national business scope, the economics of scale, and the dangers of the psychology of fragmentation all argue for diversification of participation in the management of nationally oriented guarantors.

If the capacity of the reserves now required of the mortgage guarantor could be shown to be adequate to meet foreclosure frequencies appropriate to severe national recession, then the issue of whether the guaranty were truly insurance would devolve on the problem of securing average losses equal to or better than national averages. To the degree that the industry is fragmented and fails to produce a book of business for each guarantor, which reflects diversity of geographic dispersion, institutional practices, loan ratios, and seasoning of portfolios, it falls short of insurance requisites for catastrophe control.

It remains for another essay to explore techniques for measuring reserve adequacy and possibilities for further statesmanship among industry and regulatory leaders to assure full acceptance of the mortgage loan guaranty as a proper function of the insurance industry.

[42] Groups of incorporators of guarantor firms with a local or regional interest to serve have secured only minimal amounts of initial equity capital in 1957 or 1966.