Thrift Bulletin

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Substitute Mortgage Insurance for Ticor Mortgage Insurance Corporation (TMIC) Loans

Summary: Many insured institutions have experienced difficulty in procuring substitute mortgage insurance on loans previously insured by TMIC. A private mortgage insurance company known as Policyholders Benefit Corporation (PBC) has been organized to offer replacement coverage for former TMIC policyholders. The bulletin also establishes criteria for the self-insurance of previously-insured TMIC loans.

For Further Information Contact:
The FHLB District in which you are located or the Policy Analysis Division of the Office Of Regulatory Activities, Washington, D.C. 20006.

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Introduction

All loans previously insured by TMIC under mortgage guaranty insurance policies were formally canceled by the entry of the order of liquidation by the California Insurance Commissioner on April 27, 1988. The liquidation of TMIC canceled $10.8 billion of mortgage insurance, leaving policyholders without mortgage insurance on 202,000 non-delinquent, high loan-to-value (LTV) ratio loans.

The Board has previously stated that it would waive supervisory action against institutions holding performing loans previously insured by TMIC while they sought substitute mortgage insurance. Institutions were also counseled to continue to collect the insurance premiums from borrowers and hold them in a deferred account pending guidance from the Board.

Policyholders Benefit Corporation

On September 14, 1988, a new mortgage guaranty insurance company, Policyholders Benefit Corporation, was licensed in the District of Columbia. The company has been capitalized with $4 million from six private mortgage insurers. The board of directors of PBC includes representatives of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) who had significant exposure in loans insured by TMIC.

All loans insured by TMIC as of February 29, 1988 and current on April 26, 1988 are eligible for coverage by PBC. The sole business activity of PBC will be to insure these loans. It will not be writing any new business. Institutions that choose to contract with PBC will turn over the TMIC premiums that they have continued to collect as part of the new coverage. The major features of the insurance product PBC offers are as follows:

— Premium charges will be identical to those previously charged by TMIC on each insured loan.

— The percentage coverage from PBC will be equal to the percentage coverage purchased from TMIC but cannot exceed 20 percent for a loan with an initial LTV ratio of 90 percent or less and cannot be more than 25 percent for a loan with an initial LTV above 90 percent.

— The coverage is subject to a "stop-loss" limit for each mortgage investor, which means that the maximum amount of claim payments cannot exceed 80 percent of net premiums received. Lending institutions can increase their "stop-loss" limit by paying supplemental premiums.

— As loans mature and beneficiaries exit the program, excess premiums remaining in the accounts will be distributed to all beneficiaries.

The major advantages of the PBC insurance program in contrast to self-insurance (discussed below) are: 1) a reduction in the risk of legal liability from borrowers claiming that services originally contracted for were not received; and 2) the possibility of receiving part of the distribution of excess premiums at the termination of PBC.

The Board has no objection to insured institutions that continue to hold previously-insured TMIC loans in portfolio exercising their own business judgment and contracting with PBC in order to replace canceled TMIC coverage. The management of insured institutions holding performing TMIC loans in portfolio, however, is under no obligation to reinsure with PBC, if it chooses not to do so. These lenders may continue to seek coverage from other active mortgage insurance companies or choose to self-insure accord-

ing to the guidelines established below.

Insured institutions that service TMIC loans for others must seek guidance from the new owners of the mortgages on alternative mortgage insurance coverage and the correct disposition of the premiums they have continued to collect from borrowers. For example, if the TMIC mortgages were sold to the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association, these organizations have already contracted with PBC to reinsure the TMIC loans.

Substitute Mortgage Insurance for TMIC Loans

Many, if not all, insured institutions with mortgage loans previously insured by TMIC have continued to collect insurance premiums from borrowers on the defunct policies in conformance with Board policies. Many institutions have been unable or unwilling to secure alternative mortgage insurance for two major reasons. First, a large portion of these mortgages are unable to meet the current tighter underwriting standards of private mortgage insurance companies. Second, even those previously-insured TMIC loans that are insurable by other companies will require significant premium increases to reinsure the loans.

It has come to the attention of the Board that the difficulty of securing substitute mortgage insurance has resulted in a number of institutions choosing to treat the deferred escrow account containing the TMIC premiums that they have continued to collect from the borrowers as equivalent to a self-insurance account. Among other things, this memorandum is designed to clarify the Board's position on the appropriateness of this activity for previously-insured TMIC loans.

General Policy — Self-Insurance on TMIC Loans

The Board's regulations on private mortgage insurance located at Sections 545.32(d)(2) and 563.9-7(a) make no provision for the self-insurance of loans with a loan-to-value (LTV) ratio in excess of 90 percent. Loans with a LTV ratio between 80 and 90 percent can be self-insured by thrift institutions at their discretion under the regulations. State-chartered institutions should familiarize themselves with, and adhere to, the legal and regulatory requirements for self-insurance in the state in which they operate.

The Board's general position on institutions self-insuring against potential losses on loans previously insured by TMIC is as follows. First, institutions failing their minimum regulatory capital requirements are not allowed to exercise the self-insurance option for TMIC loans unless they receive prior written approval from supervisory personnel. These institutions are under greater pressure to maximize profits and may be more willing to accept risks without having the capital necessary to absorb the risks and the losses.

Second, all insured institutions holding TMIC loans in portfolio that choose to self-insure must add the premiums from the deferred account that they have been continuing to collect from borrowers on the TMIC loans to their general valuation allowances. Although the LTV ratio on these loans has generally declined since April, 1988, the TMIC loans can still be considered high-risk loans, due to the default of the private mortgage insurer. There has also been insufficient time to adequately determine the loss experience on TMIC insured loans since the default. No premium payments may be taken into income unless the management of these institutions can demonstrate to the satisfaction of their board of directors, auditors and examiners that the component of their general valuation allowances consisting of TMIC premiums is sufficient to cover expected losses on the TMIC loans.

Third, the Board will forbear from taking enforcement or supervisory action against adequately capitalized insured institutions that choose to self-insure TMIC loans, provided that these institutions comply with the requirements stated above and those contained in the attached legal opinion from Housing and Urban Development. This opinion states that this activity is only appropriate if: 1) the termination of mortgage insurance is involuntary (as in the case of TMIC); 2) the borrower will be notified; and 3) the premiums constitute part of a fund of what is effectively replacement insurance.

Institutions that choose self-insurance for TMIC loans must maintain written documentation for regulatory personnel to determine if the self-insurance option is being appropriately exercised. The documentation should include, at a minimum, 1) a signed resolution from management that the institution sought with due diligence, but was *unable to obtain* substitute mortgage insurance, including the coverage presently offered by PBC, 2) written verification that borrowers on the TMIC loans have been duly notified, and 3) the institution's analysis of projected premium accumulations in comparison to historical and anticipated portfolio losses, including the effect of expected losses in a rising interest rate environment. For purposes of this bulletin, the term "una-

ble to obtain" means either "prohibitively expensive or demonstrably inadequate".

Finally, since institutions with TMIC loans should have been seeking alternative mortgage insurance coverage since April, 1988 and should be aware of the various alternatives in the marketplace, institutions will have a four-month time limit from the publication date of this bulletin to decide whether they will self-insure, contract with PBC or procure other alternative mortgage insurance. After that time, the Board will no longer waive supervisory or enforcement action on the mortgage insurance requirement for TMIC loans.

Darrel W. Dochow

— Darrel Dochow, Executive Director

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
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OFFICE OF THE GENERAL COUNSEL

FEB 23 1988

Caryl S. Bernstein, Esquire
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Dear Ms. Bernstein:

This acknowledges your letter of February 8, 1988 in which you raised certain questions under the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601 et seq.) related to my February 12, 1985 letter to John E. Gunther, General Counsel, Mortgage Insurance Companies of America (MICA).

My February 12, 1985 letter dealt with a condition that was of concern to MICA in 1985 wherein savings and loan associations (particularly troubled savings and loan associations) were continuing to collect private mortgage insurance premiums for their own accounts and were not remitting these premiums to the insurers. Nor was the borrower who paid these fees into escrow made aware of this diversion of fees. The practice had been the subject of several trade articles and these in turn motivated General Counsel Gunther to request an opinion from my office. The essence of my opinion was that Section 10 of RESPA (12 U.S.C. §2609) was violated when a lender continued to collect mortgage insurance premiums but ceased to pay them out. It was my expectation and Mr. Gunther's that this legal opinion would be brought to the attention of the Federal Home Loan Bank Board (FHLBB) which would in turn take appropriate regulatory action against violators of this RESPA provision who were under their supervision. Section 10 does not give HUD independent authority to act against violators.

Your February 8, 1988 letter outlines a circumstance where a major private mortgage insurer, TMIC Insurance Company (TMIC), will likely be placed in liquidation by the California Insurance Commissioner within the near future. You relate that the Commissioner will terminate all outstanding insurance policies of TMIC and that a substantial portion of mortgages covered by this private mortgage insurance are held by Fannie Mae. Under the circumstances described wherein the private mortgage insurance company is liquidated by the State, you ask whether the Gunther opinion applies if the fees continue to be collected and passed through to Fannie Mae in circumstances where no other alternate mortgage insurance may be reasonably available. We understand that you are exploring other arrangements whereby Fannie Mae would find one or more alternate insurers. However, you contemplate that until or unless alternate insurers are found Fannie Mae may become in effect an insurer of last resort in this emergency situation. You also indicate that Freddie Mac faces a

similar portfolio exposure, so that any response to you could also serve as precedent for them, as well as for other primary and secondary lenders similarly affected.

My February 12, 1985 letter dealt with specific situations where savings and loans were canceling insurance without informing the borrowers and were further continuing to use the premiums for their own expenses. Collecting fees without paying them out was viewed as a form of unjust enrichment which violated Section 10 of RESPA because funds were being diverted from the purposes for which they were suppposed to be escrowed.

You have told me that if TMIC is liquidated, FNMA will seek to nurture an alternate insurance arrangement and that borrowers who are paying these private mortgage fees will be informed of the termination of their private mortgage insurance. You also informed me that FNMA believes that the fees continue to be required under the terms of the mortgage documents and that FNMA anticipates that the fees will continue to be collected and remitted during the period while FNMA is exploring alternative insurance arrangements. You indicate that you anticipate placing such fees in a separate fund or account and that you believe that this arrangement would satisfy the mortgagor's insurance requirement.

After reviewing all of the matters as you have outlined them to me both in your February 8, 1988 letter and in our subsequent conversation, I conclude that this emergency circumstance is an exception to the position regarding fee collection set forth in my February 12, 1985 letter to Mr. Gunther. There are three fundamental differences: (1) the termination is involuntary, insofar as Fannie Mae is concerned; (2) the borrower will be notified; and (3) the fees will constitute part of a fund of what is effectively replacement insurance. I therefore conclude that Section 10 of RESPA would not be violated.

This informal opinion letter of course only deals with RESPA and is limited in effect by Section 19(b) of RESPA (12 U.S.C. §2617) (see also 24 CFR §3500.4 of the RESPA regulations). I have obtained the concurrence of appropriate RESPA staff. This informal opinion letter shall not be deemed to be an exercise of the Secretary of HUD's general regulatory powers over FNMA.

If I can be of further assistance, please let me know.

Sincerely,

Grant E. Mitchell
Assistant General Counsel
Fiscal Management and
Energy Division