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Mortgage Insurance for India

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I. Background and Objectives

Background

India's economy, including its housing finance sector, is undergoing rapid deregulation. Banking and insurance are on the threshold of moving from being owned and controlled by the centralized government to becoming decentralized, privately capitalized, risk-taking enterprises. Market forces are already driving significantly where and how financial capital flows, based on demand and priced according to risk.

Housing – officially a "favored" sector of India's controlled economy and therefore a recipient of subsidized annual credit allocations – has traditionally received such grossly inadequate amounts of capital that it could not even keep pace with population growth. With the advent of a freer market economy, housing faces a difficult transition. This transition harbors, however, unprecedented opportunities to realize real gains in both mortgage capital flows and physical production.

On the one hand, decision makers controlling the flow of capital will demand market rates of return, thereby squeezing traditional sources of affordable mortgage financing. Fiscal austerity and the drive to make India's economy more productive and internationally competitive also will leave less room for government officials and large employers to channel large subsidies into housing.

On the other hand, deregulation and a growing economy will open up huge new potential sources of mortgage capital and methods for channeling it into badly needed new housing production. Privately chartered insurance companies, banks, provident (pension) funds, and other institutional and individual investors will be seeking suitable investment-grade outlets for their growing volumes of investable funds. As 1996 begins, India's mortgage financings are already growing at an estimated annual rate of about 25 percent; even while most of the benefits of financial deregulation are still forthcoming.

To meet the needs of its burgeoning population, India must expand its supply of decent housing dramatically. The gap between available supply and need is currently estimated to exceed 35 million units and to be growing at about one million units per year. Mortgage financing sufficient to help eliminate even one half of this gap (assuming an average cost of Rs. 2 lakhs per unit with 50 percent financed) translates to a potential five-year mortgage capital flow of about Rs. 20 million lahks. Additional mortgage financing will be needed to upgrade the existing housing stock.

In recent years, India's specialized housing finance companies (HFCs) have been providing the bulk of institutional funding for home purchase – a national market estimated at over Rs. 100 billion. Serving as deposit institutions as well as mortgage lenders, HFCs somewhat resemble the U.K.'s building societies or the savings and loans associations of an earlier era in the U.S. Whether India successfully exploits financial deregulation to expand the delivery of needed

mortgage capital and narrow the housing needs gap will depend in large part upon the evolution and performance of these HFCs. Because HFCs operate under the aegis of the National Housing Bank of India (NHB), NHB's leadership role is also crucial to the system's sound growth.

India's housing finance system today operates only in the context of a "primary" mortgage market. That is, all mortgage lenders – and most significantly all HFCs – keep in their own portfolio whatever mortgage loans they make. Consequently, with limited tools and flexibility, they must face the constant challenge and risk of assuring adequate sources of funds, matching mortgage and funding maturities, maintaining adequate asset-liability spreads, and holding sufficient capital reserves. All this in addition to the basic business of making good loans and keeping them current.

A number of nations with developed financial sectors have – with government help – created a secondary market for mortgage loans, whereby primary lenders can resolve the financial management dilemmas noted above by selling their mortgage loans to third party investors. Secondary market loan sales not only expand long-term funding flows, but also permit primary housing lenders to focus on their main mission: originating and servicing home mortgages.

Insuring mortgages against loss by reason of borrower default can expedite the workings of both a primary and a secondary mortgage market. With insurance, primary mortgage lenders can be induced to extend credit to additional potential homebuyers with more permissive financing terms, thereby expanding the homebuying market. With insurance, secondary mortgage investors can be induced to purchase mortgage loans (either directly or in securitized form) that they would otherwise consider too risky or complex. In short, mortgage insurance serves to expand the flow of financial capital into housing, thereby stimulating home construction and improvement and increasing the rate of homeownership.

The India Housing Finance Expansion Project

India's existing mortgage finance system possesses certain key components that operate effectively, that are primed to thrive and grow under deregulation, and that could even serve as a model for other developing industrial nations. Key leaders, however, have recognized that the current housing finance system is not prepared to take full advantage of, nor operate soundly in, a substantially deregulated environment. The system as presently structured will not be able to close significantly the identified housing needs gap. Without major innovation and further development of the housing finance sector, India's large, emerging middle class will remain underhoused, while the problems of housing India's poorest will become even more vexing.

In 1992, the National Housing Bank of India and the U.S. Agency for International Development (USAID) commissioned a four-year project to upgrade the strength, breadth, and capacity of India's housing finance system in an era of financial deregulation. The goals of this project, implemented under the auspices of Abt Associates, Inc., are to:

- Develop and expand India's private housing finance institutions
- Increase domestic sources of mortgage funds

- Establish joint pilot programs between NGOs (non-profit, nongovernmental organizations) and housing finance institutions to expand lending to households with below-median income

- Assist the NHB in its role as an apex housing institution, including lender regulation and supervision and introduction of a secondary mortgage market

This report evaluates the feasibility and potential usefulness of providing mortgage default insurance as a means of expanding housing affordability via increased availability of mortgage funding. This mortgage insurance study is one of the many components comprising the Housing Finance Expansion Project. Mortgage default insurance, as addressed in this report, touches to some degree most, if not all, of the larger project's goals as outlined above.

Objectives and Conduct of Mortgage Insurance Study

The mortgage insurance study component of the India Housing Finance Expansion Project was conducted with the following objectives:

- To evaluate whether India's residential mortgage market, both current and near term, can utilize mortgage insurance to increase mortgage capital flows. This evaluation entailed:

  - Identifying factors that favor the effective use of mortgage default insurance

  - Identifying factors that impede the effective use of mortgage default insurance

  - Recommending practical means for overcoming identified impediments

- To articulate what type(s) of mortgage default insurance schemes should best meet India's needs, given the unique circumstances of India's housing and mortgage markets. In this regard, special consideration is given to the needs of households earning incomes below the median.

- To recommend workable roles and relationships for current and prospective mortgage market participants (both public and private) in a national mortgage default insurance program

The work program supporting this study included:

- Reviewing relevant published materials, including related studies performed under the sponsorship of the India Housing Finance Expansion Program

- Discussing with researchers their work in preparing prior related study components

- Conducting interviews with Indian mortgage lenders, National Housing Bank officials, homebuilders, rating agency executives, and NGO leaders concerned with housing needs of lower-income persons

- Assembling relevant information on mortgage default insurance as it is used in other nations

- Drawing upon prior personal experience and knowledge from managing a large mortgage insurer in the U.S. and consulting to mortgage insurers in the U.S., Canada, and New Zealand

- Seeking to adapt external mortgage insurance information and experience, as noted above, to the unique situation in India

II. Basic Principles Applicable to Mortgage Default Insurance

Mortgage default insurance (MI) is in some respects unique among insurance lines. However, MI does share common insurance principles with other general lines, including:

- The transfer and spreading of defined risks so that individual assumptors of risk are not subject to ruinous random events
- "The law of large numbers," or the pooling of a sufficient number of identified risks so that aggregate losses become manageable
- Actuarial basis: defining, grouping, measuring, predicting, and pricing the risks being assumed
- Insurer solidity: defining the level and composition of policyholder reserves relative to risks assumed in order to assure the insurer's continued claims-paying and risk-taking capacity
- Regulatory oversight: a framework of third party (government) review to assure prudent management of assets and risks for the long-term benefit of insurance policyholders
- Avoiding "adverse selection of risk," or policyholder behavior that causes the insurer to receive and accept risks that are excessive (relative to premiums collected) because the risks are not randomly selected
- Avoiding "moral hazard," or behavior by the insurer and/or the policyholder after the insurance is issued that causes the loss incidence or severity to become greater than anticipated at the point of underwriting

In addition, mortgage default insurance – regardless of its specific program features – exhibits the following special characteristics:

- *The risk assumed depends upon broad economic trends and public policies.* The type of public policy affecting mortgage insurance risk includes, but also goes beyond, national macroeconomic policies impacting income, employment, interest rates, and housing demand. Policies at all levels of government involving taxation, the supply of buildable land, foreclosure laws, environmental laws, building regulations, etc. can raise or lower significantly home mortgage default patterns.
- *The critical MI risk is "catastrophic."* In other words, mortgage default risk is not limited to, nor is it primarily a product of, the "normal" risk that an individual homeowning household might experience in terms of financial adversity, resulting in foreclosure. Rather, a "catastrophic" risk refers to the widespread foreclosures that may occur as a result of economic depression at the regional or national level. For this reason, mortgage insurance may present the most significant example of catastrophic risk coverage of any insurance line.

- *The horizon of risk assumed under each individual MI policy is unusually long.* Home mortgages are long-term instruments – typically extending for at least 15 years. To serve its intended purpose, therefore, mortgage default insurance must be noncancellable by the carrier. As a practical matter, the premium is typically fixed for the life of the policy at the outset, despite the likelihood of changing risk conditions during the life of a mortgage loan.

- *The unusual combination of credit and collateral risk.* The "event of loss" under a mortgage insurance policy is the borrower's failure to make required periodic repayments, in other words, to default.

  The risk of actual loss occurring also depends on the occurrence of a second event following borrower default, namely, the lender's inability to recover the full debt owed through disposition of the collateral property.

- Unlike most hazard insurance risks, inflation reduces, rather than increases, the risk of mortgage insurer loss.

- Establishing long-term catastrophic loss reserves is necessary to address the unique risks associated with the contingent probability of future economic depression. Consequently, MI is more capital-intensive than other insurance lines.

- Premium rates, while risk- and experience-based, lack the actuarial precision of most insurance lines. Premiums must be adequate to cover future economic catastrophe in addition to predicted frequencies and severities of default-related losses associated with a normal economic cycle.

- Moral hazard applicable to MI can arise from both the insured's underwriting behavior prior to placement of the risk and the insured's servicing (collections) behavior over the term of coverage.

III. Conditions Essential for Mortgage Default Insurance to Function in India

Because mortgage default is a form of institutional financial guaranty, the establishment of a viable (i.e., long-term, self-sufficient) mortgage default insurance scheme in India will depend upon a range of pre-existing conditions in the financial services sector as well as in the larger national economic environment. These environmental preconditions would apply regardless of whether the source of MI sponsorship and ultimate risk assumption is government-based, private enterprise-based, or some combination of government and private sponsorship. A purely government guaranty would, of course, be less subject to both the financial disciplines of the marketplace and private institutional arrangements, while more dependent on the national treasury for its long-term viability.

Institutional Insurance Environment

To the extent that private sector capital supports a mortgage insurance scheme – with or without government backup – India will need an *institutional insurance environment* characterized by:

- An established framework (or enabling legislation) for the creation of an insuring entity authorized to write mortgage default insurance risk.
- A mechanism for establishing competent regulation and independent evaluation of the operations of the mortgage insuring entity – in particular, its long-term claims-paying capacity.
- The ability to mobilize sufficient risk capital to establish initial mortgage insurer policyholder reserves.

A mortgage insurance scheme operated entirely by a government agency would not, of course, depend upon the prior creation of an institutional insurance environment. Only enabling legislation, regulations, and appropriations would be needed.

Institutional Mortgage Lending Environment

Beyond insurance-related prerequisites, a more extensive array of preconditions relating to the *institutional mortgage lending environment,* must be operative. These include:

- A defined need for a mortgage default insurance product. Lender recognition of the need is essential; borrower recognition would be desirable.
- A market potential sufficient for the principles of risk spreading and the "law of large numbers" to operate effectively
- Institutional mortgage lenders whose financial staying power can be attested to by objective third parties
- Mortgage lenders capable of performing consistently responsible loan underwriting

- Mortgage lenders capable of performing consistently responsible loan servicing (e.g., collections and recovery)

- Mortgage lenders able and willing to conform to standardized underwriting definitions and criteria for purposes of securing mortgage default insurance

- Lenders ability to secure reliable information on financial capacity and personal character of borrower-applicants

- Lenders able and willing to assemble and efficiently convey to a mortgage insurer loan data essential for the purpose of evaluating and managing insured risk over time

- Consistent and reliable methods for documenting the market value of homes

- An effective system for establishing clear title to residential properties

- An active home sales and resale market not unduly restricted by excessive transaction costs

- A legal and political environment which, in the event of incurable mortgage default, will permit recovery of collateral property in a reasonable period of time and for a reasonable cost.

Additional Precautions

Finally, in addition to insuring and mortgage lending considerations, several functional preconditions are important to the viability of a prospective mortgage insurance undertaking:

- A mortgage default insurer must be able, over time, to charge premium rates adequate to cover actual and projected losses, thereby permitting profit margins sufficient to attract the additional capital to sustain new writing capacity. In this regard, mortgage experience data should be available that can demonstrate insurable levels of default frequency and loss severity. Alternatively, the nation's housing market and mortgage lending environment need to show sufficient stability to support rational *pro forma* claims and loss projections during the MI's startup phase. (Regarding the setting of premiums, the established rates need, in any event, to include a significant component for catastrophic loss coverage.)

- Launching a *de novo* mortgage insurer – regardless of sponsorship – requires identification of experienced persons with appropriate management and operating skills.

- Control of moral hazard requires practical methods of sharing risk with policyholders that are acceptable to mortgage lenders seeking insurance.

- The national economy must be sufficiently stable so as to render the likelihood of a catastrophic risk event extremely remote for the foreseeable future. Alternatively, a mechanism for shifting the catastrophic risk component to the central government must be available.

The above-referenced matters are discussed in further detail in Section V.

IV. *Institutional Insurance Environment: Prospectively Favorable for Mortgage Insurance*

As of early 1996, India has no suitable insurance framework for the establishment of a mortgage default insurance vehicle. Continued deregulation of the nation's financial services sector, including the insurance function, appears virtually assured. However, the ending of the current government's insurance monopolies and the issuance of charters for new private insurance enterprises almost certainly will not occur until after the upcoming general elections. The likely pace of insurance deregulation thereafter remains uncertain and is subject to continuing political opposition, although some observers believe that general lines (property and casualty) will be permitted to privatize more rapidly than life insurance.

In the meantime, the current government insurance monopolies do not appear inclined to begin issuing government-sponsored mortgage default guaranties. Nor are they prepared to launch and manage a market-driven, actuarially sound mortgage insurance operation. The life insurance monopoly, LIC, owns a housing finance subsidiary (LICHF) that is just emerging from a difficult period of rapid portfolio growth and a fallout of very high loan defaults. With deregulation and the challenges of adjusting to market competition imminent, it appears unlikely that either LIC or GIC (India's general lines insurance monopoly) is positioned to engage in a new, highly specialized business of assuming catastrophic economic risks.

The prospective shape of India's deregulated insurance industry should offer an environment amenable to the establishment of a sound MI venture, either independently or in cooperation with an appropriate arm of the central government. The basic framework for a privatized insurance industry has been put forth by the Malhotra Committee. Key elements of the Committee's proposals include:

- The granting of new charters, including charters for general lines (property and casualty)
- Minimum required startup capital of Rs.100 crores
- The establishment of a new insurance regulatory authority (IRA)
- The structuring of the privatized insurance sector to permit an inflow of international risk capital

At least one established private investment rating agency, CRISL (Credit Rating Information Services of India, Limited), clearly possesses the core competencies, a sophisticated staff, and indicated incentives to rate the new general lines insurers, including, by implication, any such carrier that would choose to engage in writing mortgage default insurance. CRISL's rating activities demonstrate a strong orientation toward the financial services and real estate sectors, including closely related experience in rating HFCs, banks, and builders. In anticipation of further financial services deregulation, CRISL management has given serious attention to the dynamics of the insurance business in general and financial guaranties in particular.

National Housing Bank executives have expressed their support for the establishment of a soundly conceived mortgage insurance entity in the context of financial services and insurance deregulation. While the NHB itself is not directly positioned within the insurance sector, the creation of MI capacity in India would depend upon active NHB collaboration with the appropriate insurance authorities.

A number of key HFC executives appear committed to active involvement in any private insurance sector that evolves. Life insurance and several general insurance lines are closely related to the residential mortgage business, so it will make strategic sense for HFCs to seek opportunities for growth and synergy via the privatizing insurance sector. Unless serious regulatory or other obstacles arise, the currently expressed interest in becoming *users* of mortgage default insurance on the part of HFC managers will almost certainly ripen into entrepreneurial initiatives to become MI *providers* when the opportunity materializes.

However, India's housing finance system may eventually evolve (trends in other countries suggest movement away from specialized mortgage finance providers) in the near term, HFCs would be *the* central stakeholders in any form of mortgage default insurance. HFCs possess (at least collectively and prospectively) sufficient resources to capitalize one or more general lines insurers, including a possible writer of mortgage default insurance. The largest HFC – Housing Development Finance Corporation (HDFC) – has already undertaken specific actions to collaborate in the formation of a new insurance entity (not MI) in anticipation of insurance sector deregulation. HDFC has studied the mortgage insurance business, although it has no expressed plans to write mortgage default insurance.

Finally, because housing is still a priority sector within India's public policy goals for capital allocation, and because options for direct capital allocation will inevitably recede as deregulation proceeds, it stands to reason that public policy will most likely support the establishment of a viable mortgage insurance function. MI's fundamental purpose, after all, is to induce the flow of capital into housing.

V. Institutional Mortgage Lending Environment: Generally Favorable for Mortgage Insurance, but with Notable Exceptions

Most of the essential conditions conducive to the development of a sound mortgage insurance program in India already exist (outlined in Section III above). Nevertheless, certain impediments to MI within the mortgage lending sphere warrant serious remedial attention. Most notably, the question of collateral recovery must be addressed before a cost-effective MI program is established.

Market Size and Diversity

On the positive side is India's sheer size. By any measure, India possesses the required scale for spreading insured mortgage risk: three million square kilometers of land (one third the size of the U.S.); a population approaching one billion (of which a rapidly growing middle class currently estimated at 150 million comprises a potential homeowner base roughly equal to that of the U.S.); a federation of 25 separate states; and many diverse regional housing markets.

Lender Recognition of Need

There appears to be remarkable consensus among HFC managers regarding the need for, and the benefits to be derived from, the availability of mortgage default insurance.

These perceptions are not vague or ill-defined. The current posture of HFCs may be characterized as "underwriting to zero losses." (HFCs interviewed for this study are believed to represent a representative profile among the leading NHB-approved HFCs. A listing of those interviewed appears in Appendix L). Under the pressure of relatively narrow spreads and a rising cost of funds, HFC profitability appears highly dependent upon holding loan arrearages to an absolute minimum; actual write-offs have been almost nonexistent. The only temporary exception to this underwriting posture in recent years has been LICHF, which reportedly has experienced delinquency rates exceeding 10 percent. To date, even LICHF has avoided major loss write-offs.

A policy of "underwriting to zero losses" manifests in extremely conservative underwriting criteria. While rational in light of unforgiving HFC spreads, such an underwriting posture also significantly constrains lending volume. A lending program that consciously expects two to three percent of all loans made to result in default will result in approval of many more qualified applicants than a program that endeavors to eliminate all prospective defaulters. Mortgage default insurance is recognized as a vehicle that will induce mortgage lenders to move away from "underwriting to zero losses" and permit them to "expand the envelope" by serving applicants previously deemed unqualified. The incremental default risk would be insured, while the cost of assuming the added risk would be absorbed – either directly or indirectly – in the form of insurance premiums paid for by a greatly expanded population of qualified borrowers.

More specifically, HFCs agreed that mortgage insurance ought to be initially targeted to serve a significant class of borrowers who, in all respects except one, closely mirror the profile of borrowers currently served. The key change would be that MIs would induce lenders *to reach prospective home purchasers at an earlier age* – and therefore at an earlier stage of household formation and savings accumulation. Initially this is how mortgage insurance availability would contribute to expanded lending and home ownership.

For example, HFCs describe today's typical applicant as a married man in his late 30s – reflecting, by India's recent past standards, a continuing trend toward younger first-time home purchasers. Mortgage insurance availability should enable that typical applicant to qualify for a loan several years earlier than he could under prevailing underwriting standards. Instead of marrying and living with parents and possibly even young children for an extended number of years while increasing his income and saving to qualify for home financing, such an applicant would qualify for a given level of financing sooner with less income and less margin money.

With home prices often rising faster than incomes, the applicant could achieve homeownership sooner by assuming a somewhat higher initial payment burden (IIR) with the use of mortgage insurance. (See illustration on Page 24.) For this expanded, younger market segment, all other conservative underwriting parameters except the IIR could remain unchanged.

All HFC managers interviewed concurred that the incremental risk of default associated with moderately higher IIRs should be manageable with the support of a properly designed MI program. There appears to be no empirical data available from India or elsewhere suggesting otherwise.

An ancillary benefit of using mortgage insurance to enhance mortgage affordability, most interviewees observed, would be to reduce current tendencies to borrow margin money in the "informal" sector at very high rates and without the HFC's knowledge. Such a practice is conceded to be growing, is hard to detect, and is self-defeating in that the borrower assumes at the outset excessive payment burdens that, over time, destabilize the entire transaction in the event of even mild financial adversity during the loan's early years.

Other borrower groups identified by HFC managers as currently underserved, who might be reached through judicious use of mortgage insurance, include:

- Salaried applicants whose employers (and therefore whose incomes) are considered to be somewhat less stable than the incomes of borrowers employed by India's largest corporations and government agencies.

- Certain non-salaried applicants, e.g., self-employed professionals, whose demonstrated means of livelihood may be stable, but whose incomes and resources are difficult to document.

In contrast to the use of MI to underwrite younger borrowers, the specific means for underwriting currently unserved self-employed individuals would require considerable effort to develop. Self-employed borrowers – both in India and internationally – present inherently higher underwriting risks and costs, which need to be carefully controlled. Likewise, the methods for evaluating

income stability for borrowers who work for smaller or less-established employers would require cautious implementation.

In considering where and how mortgage default insurance might expand responsibly India's homeownership market, a fine line must be drawn by both MI users and providers. Any attempt to use mortgage default insurance as a substitute for prudent, thorough loan underwriting will eventually result in failure. Both users and providers of MI must be sophisticated enough to understand where and how the underwriting envelope can be expanded without assuming excessive or unintended risks.

Strength of Housing Lenders

A mortgage insurer's ability to manage risk and operate in an actuarially sound fashion depends on the competency and soundness of its policyholders, who, as lenders, create and select the risks to be insured. India's top-tier HFCs, all NHB-recognized, exhibit the requisite strength and staying power to qualify as mortgage insurance policyholders. In addition to NHB qualification, evidence of these strengths includes:

- Generally strong ratings from CRISL (The Credit Rating Information Services of India Limited)
- Public stockholders and, in many cases, large bank or other institutional affiliations
- Operating track records of at least five years

This study investigated whether a critical mass of solid capacity exists among the top tier of housing lenders for India to support the launching of a successful mortgage insurer. It concludes that such a critical mass does exist.

Housing Lenders' Underwriting Competence

Establishing the baseline credentials of a probable core group of lender-policyholders is necessary but not sufficient to determine the likely viability of mortgage insurance in India. Most, if not all, top-tier HFCs exhibit both the ability and commitment to underwrite home loans conservatively and thoroughly. Furthermore, additional second tier lenders – beginning with, but not necessarily limited to, the remaining group of about a dozen NHB-recognized lenders – may also be capable of originating and servicing mortgage loans that would meet the standards of a mortgage default insurer. Such determinations should be made case by case, following a successful startup period during which participation would be limited to top-tier HFC lenders.

Evidence of HFC Capability to Conform

While current underwriting rules may not all conform precisely to a prospective insurer's requirements, the leading HFCs clearly possess the capability to conform, evidenced as follows:

- Favorable credit underwriting performance is indicated by generally low delinquency rates over time for most leading HFCs. (The fact that the method of measuring and reporting delinquency rates needs improvement and standardization does not invalidate this finding.)

- Prospective borrowers are carefully scrutinized in personal interviews by experienced interviewers – a costly underwriting procedure no longer carried out by most U.S. lenders. (The fact that the method of recording and reporting the results of borrower interviews could be more systematic and thorough does not invalidate this finding.)

- Borrower income components reported are verified through third parties. HFCs appear to possess good knowledge of major employers and generally avoid making loans to employees of unfamiliar employers.

- Bank deposit verifications are routinely carried out.

- Reasonable efforts are made to document borrowers' source(s) of margin money, to avoid undisclosed borrowings and overstatement of borrowers' cash contribution. (Note: this is an area that should be strengthened as the culture of prospective applicants becomes inevitably less debt-averse. A mortgage insurer may require more stringent documentation of margin money sources; HFCs seeking insurance would probably comply.)

- References given in the borrowers' loan application are generally, though not always, checked.

- Property valuations typically are performed by competent, designated professionals. (Note: mortgage lenders in other market economies generally rely on "comparable sales" data to support valuations for lending. An MI in India should seek to require such confirmations of value.)

- Frequent HFC reliance on individual guarantors (who are also underwritten, though perhaps not as thoroughly) and assignment of insurance and provident fund cash values serve to reinforce loan quality and help to compensate for the absence of a formal credit reporting system.

- Repayment reinforcing devices, including direct debit payments and post-dated checks (PDCs) given at the time of loan origination, are often required.

- Collateral security, in terms of establishing good title, appears subject to sound procedures.

- HFCs appear to employ highly experienced loan officers ("appraisers") who possess a conservative underwriting orientation. (It will be critical for such conservative orientation to be retained as HFC managers seek sustained growth in loan volume with default risk reduced by insurance.)

Areas of Weakness

Although the preponderance of HFC underwriting observations are positive, several significant weaknesses would also stand out when viewed by a mortgage insurance risk manager considering approval of a lender as a new insurance policyholder:

- Underwriting checks performed tend to be insufficiently documented by some HFCs.
- Underwriting is heavily tilted toward borrower repayment over collateral value – due in large part to India's presently unworkable foreclosure laws.
- HFCs appear overconfident that home values will continue to rise indefinitely. This attitude could prove hazardous in the future because it may prevent HFCs from recognizing and reacting quickly to market warnings of a sudden decline in home values.
- The concept of quality control (i.e., post-underwriting audit of recent loans to determine compliance with established underwriting policies and document requirements) does not appear to be well developed.
- Verification that margin money claimed by the borrower is not borrowed from a third party may need to be conducted more aggressively to assure that an equity cushion sufficient to control risk is present in all cases as claimed.

A mortgage insurer, in order to operate efficiently and charge affordable premiums, is not well positioned to re-underwrite every individual loan that lender-policyholders seek to insure. At best, the MI will be able to perform a case-by-case underwriting review and a periodic in-depth audit. MI reliance on the integrity of the HFC's underwriting is critical. In light of this dependency, the underwriting weaknesses identified above must be considered serious. However, when measured against the positive findings, these shortcomings are neither so severe nor so incorrigible as to invalidate the overall finding that HFC underwriting practices should protect sufficiently the risk exposure transferred by the HFC to a third party mortgage insurer.

A distinction needs to be drawn between underwriting *standards* and underwriting *documentation*. Regarding HFC underwriting standards, lenders seeking to avail themselves of default insurance would need to adapt externally imposed MI underwriting standards, which would inevitably involve modifications to existing standards – *but only for those loans requiring MI coverage.* A review of sample underwriting criteria currently applied by HFCs suggests that such adaptation should not be difficult.

Lack of standardized underwriting documentation has been cited by some as an observed underwriting weakness of the HFCs. Variations among HFCs with regard to loan documentation present a more serious obstacle to the goal of establishing a secondary mortgage market and mortgage securitization. For a mortgage insurer, the absence of standard documentation is more an inconvenience and a drag on efficient underwriting review than it is a risk management issue. Mortgage insurers in the U.S. functioned quite well for over a decade before the advent of a national secondary market mandated uniform loan documentation. Mortgage insurers in other

countries, such as Australia and New Zealand and Canada, operate successfully today without standardized lender documentation.

Housing Lenders' Servicing Competence

The HFCs that provide the bulk of the nation's financing for home purchases also exhibit effective collection practices and results. In particular:

- Delinquent borrowers are contacted early and are visited personally by the lender after the second or third overdue installment.
- Regional loan officers (appraisers) are generally responsible for handling collections on their own delinquent loans.
- Peer pressure – apparently much stronger in India than in many other areas – is effectively brought to bear on delinquent borrowers. The system of loan guarantors appears to be fulfilling its intended function, when defaults occur.

Delinquency reporting methods need improvement and standardization. Even at present, however, a mortgage insurer seeking to qualify potential master policyholders among prospective HFCs would have little difficulty making an informed judgment about loan servicing capability and performance.

Property Valuations

A mortgage insurer commencing operations in India would probably seek to strengthen methods currently employed by lenders to establish and document the market (i.e., resale) value of properties being offered as loan security. Such changes may provoke debate, as the current system is thorough, professional, and has worked well to date. The current cost-based system of performing residential valuations does not rely primarily on sales and market data. The weakness of such a system is not readily apparent and may not become so for some time, i.e., until India experiences a period of widespread home price deflation.

The current lack of emphasis on collateral recovery in the event of borrower default – a natural outgrowth of the nation's unworkable foreclosure laws – may also impede an early move toward more comprehensive, and therefore more costly, property valuations.

The need to strengthen the collateral valuation side of underwriting as a prerequisite to a system of insured home mortgage lending is offset somewhat by the likelihood that even increased loan amounts achievable with the use of MI will not bring real loan-to-value ratios above 75 percent in most cases. Consequently, tolerable margins of error on valuations may be greater in India than in the U.S. and elsewhere, where the loan-to-value ratios of insured home loans are typically 90 percent or higher.

Risk Management Data

Some HFCs currently appear to possess information and reporting systems capable of providing a prospective mortgage insurer with essential underwriting and risk management data. Such data would include loan level information on the insured borrower, and the property, key characteristics of the loan itself, and meaningful aggregated information on the status and performance of the lenders insured loan portfolio.

HFCs not currently possessing such capabilities, if sufficiently motivated by the benefits accompanying access to MI, should be able to develop workable data capture and reporting systems without undue time or expense.

Ownership and Transfer of Property Title and Liens

A system for establishing clear title to mortgaged properties – essential to the functioning of a *bona fide* mortgage insurer – appears to exist in a workable, though not particularly efficient, form. The transactions costs relating to transfer of title and recording of liens, however, are excessive in most states. Such levies (e.g., stamp tax rates well over 10 percent) should not, in and of themselves, render MI infeasible. Maintaining such levies, however, will raise the cost of mortgage default insurance, because they will increase significantly the loss severity of every insurance claim paid – the direct result of excessive collateral recovery costs and depressed net realizable values on property resales.

Unworkable Foreclosure System

Residential mortgage foreclosures, when pursued to execution, are reported to require typically more than ten years. Successful foreclosure completion, furthermore, is not guaranteed, even when established legal procedures are followed meticulously. Because mortgage default insurance implies some level of reliance on pledged collateral in addition to borrower credit, the absence in India of a reliable default remedy in the form of foreclosure and recovery presents the greatest single impediment to the development of a successful mortgage insurance scheme.

Various methods may be employed to circumvent the lenders' – and prospectively the insurers' – inability to recover the collateral property of a defaulting borrower. Such methods clearly strengthen the ability to alleviate or cure delinquencies. They do not, however, address the incurable cases – the ones that cause the largest losses.

International standards for traditional MI product design require lender repossession and tender of the collateral property as a condition of perfecting a mortgage insurance claim. Even so-called cash flow guaranties in other nations' mortgage default systems typically rely upon the ultimate recoverability of the underlying property. In most instances this process requires one year or less.

It is, of course, possible to change the prevailing concept of mortgage default insurance and to design an alternative program to fit the particular situation in India, where it is presently nearly impossible to recover collateral properties. (Appendix G, for example, describes a special

French guaranty system developed expressly to deal with systemic problems of collateral recovery.) The critical question would then would shift from theoretical product design to overall cost and feasibility. This question is addressed further in Section VII below where actuarial considerations are discussed. Suffice it to say here that an open-ended MI claims liability without a reasonable prospect of salvage (collateral recovery) translates directly into significantly higher premium rates. The added changes, in turn, raise cost-benefit and market acceptance issues.

Foreclosure reforms proposed to date, involving specially empowered foreclosure tribunals, face an uncertain future in two respects: (1) political uncertainties regarding whether such laws will pass, although prospects seem more promising for current proposals than for previous ones; and (2) even should the necessary foreclosure reforms be legislated, skepticism remains that meaningful implementation at the local level will be thwarted, particularly when it comes to recovery of physical possession of the property following recovery of legal title.

VI. Suggested Mortgage Insurance Program Parameters for India

Designing appropriate parameters for a mortgage insurance program in India would entail carefully integrating the principles outlined in Section II above, and identifiable "best practices" from MI programs abroad with Indian economic and cultural variables. Key to any program's marketing and financial success, furthermore, would be achieving a proper balance between: (1) the *lender's* need for sufficient protection so as to induce a useful, but not extreme, relaxation of underwriting criteria; and (2) the *insurer's* need to protect against "moral hazard" and "adverse selection of risk" – both forms of possible behavior by the insured lender that would lead to increased risk beyond insurable levels. In general, a risk-sharing or "coinsurance" arrangement between the insurer and the originating lender has proven effective for addressing both moral hazard and adverse selection concerns.

Based on field research conducted in India and on extensive reference to mortgage insurance experience outside India, the following general program parameters would appear to meet the needs of the emerging Indian mortgage market:

Insurance Coverage

1. Coverage of first-tier losses amounting to one-half to one-third of the lender's total outlay through completion of foreclosure should enable a mortgage insurance program in India to achieve the goals described above. Covered items would include outstanding principle in default, accrued interest, taxes, essential property preservation costs, attorney's fees (possibly subject to a set limit), and other legal and court costs. Coverage would be payable in a lump sum upon completion of foreclosure or transfer of title to a third party buyer. This limited level and structure of insurance protection would be effective only if accompanied by foreclosure reforms that rendered collateral property recoverable within a reasonable period of time.

2. In the absence of foreclosure reforms, some form of enhanced coverage probably would be needed in order for mortgage default coverage to fulfill its intended purpose, i.e., inducing lenders to expand their underwriting parameters to include borrowers currently considered too risky. This enhanced coverage would provide relief from incurred losses during exceedingly long legal and court proceedings by providing periodic reimbursement of a significant share of interest arrearages. For example, such enhanced coverage might entail annual or semi-annual reimbursement of anywhere from 50 to 80 percent of accrued unpaid interest – possibly subject to an absolute time limit of, say, 60 months. Enhanced coverage options providing for longer term, more frequent, and/or higher percentage reimbursements could be offered for correspondingly higher premium rates. Under any alternative plan, however, the lender responsible for collections should retain some meaningful residual risk exposure.

3. If property resale proceeds or other resolution of the case results in a loss to the lender of less than the amount of claim payments advanced (i.e., a "gain"), then a proportionate share of any such gain should be reimbursable by the insured lender to the MI.

Premium Payment/Policy Term

1. Mortgage insurance programs outside India encompass a variety of premium payment schemes, including annually renewable premiums, prepaid premiums for the life of the policy, and even monthly premiums. MI premiums may be paid by the lender and built into the interest rate, the up-front fees, or even financed over the life of the loan as an add-on to the loan's principal balance. Given various options, HFCs interviewed all preferred a combination of: (1) a lump sum premium paid up front for the life of the policy, i.e., no renewal premiums; and (2) the full MI premium added to the original loan balance and effectively financed over the life of the loan. The second option would be administratively simplest and, perhaps more important, most palatable for borrowers. It is commonly used in other countries with active MI programs.

2. The mortgage policy term could extend uniformly for the full life of the loan. Alternatively, optional policy terms shorter than the full loan term – for example, five and ten years – might also be offered. Higher premium rates would apply for the longer coverage terms.

3. Shorter loan terms should carry lower premium rates for any given policy term. For example, a five-year MI policy on a ten-year loan should carry a lower premium rate than a five-year policy on a fifteen-year loan.

Construction-Related Risk Protection

Mortgage insurance coverage before a borrower occupies a completed property usually is not offered or required in other countries. The Indian housing finance system is somewhat unusual in that construction advances are made as an integral first phase of borrower's permanent loan. Regarding possible default exposure during the period of construction, two MI policy options would appear to suit the needs of India's HFCs:

1. A higher-cost option to take effect upon extension of the lender's first construction-related advance; and

2. A lower-cost option to take effect upon issuance of the certificate of completion (or certificate of occupancy).

Such an option is offered in Canada, whereas construction phase coverage is prohibited by regulation in the U.S.

Insured Loan Underwriting

For logistical and service reasons, it may not be practical in the Indian market context for a mortgage insurer to review and approve coverage for each individual loan before coverage is committed and the loan is made. In lieu of MI underwriting review of individual loan packages, the following general arrangement should be workable:

- The lender ("master policyholder") may certify, i.e., activate, insurance coverage on all loans that have pre-agreed, documented parameters both acceptable for, and requiring of, mortgage default insurance coverage.

- The ground rules for determining all loans that are to be insured by each master policyholder (and, by implication, which loans will remain uninsured) would be formally established in advance, thereby avoiding both adverse selection of risk by the lender against the insurer and the designation of substandard loans for insurance.

- The MI might enter into standard insuring ("delegated underwriting") agreements with all master policyholders (U.S. model), or it might negotiate individual insuring agreements (possibly with varying premium rates and terms) with different HFCs (Australia/New Zealand model).

- A detailed record of all loans certified for insurance by each master policyholder would be submitted weekly to the MI (or possibly more frequently), together with remittance of the appropriate premium due.

- The MI would conduct regular on-site audits of insured loans (either all such loans or an appropriate sampling). Noncomplying loans, or loans containing materially false information, would be subject to voiding of coverage and return of premium. If certain insured loans are to be selected for transfer into a secondary market pool, prior insurer review would serve to reinforce loan quality and investor confidence.

- The mortgage insurance policy *must* be noncancellable by the insurer, except for reasons of noncompliance, misrepresentation, or nonpayment of premium. However, partial premium refunds may be made in the event of early loan payoff or early termination of insurance by the lender for other permissible reasons. Alternatively, insurance may be offered at a somewhat lower cost whereby no refunds are made in the event of early termination.

The above parameters are illustrative only. In practice, many variations on this suggested framework may be equally suitable. Appendix J presents two sample "master policy" insurance contracts which illustrate typical coverage terms offered in the U.S. and Australia.

One alternative form of "mortgage insurance" bears noting at this point. It would be possible for India's largest, most geographically diversified home mortgage lenders to perform for themselves the basic functions of a mortgage insuring entity, i.e. to "self-insure." Several of the largest California-based U.S. lenders, for example, "self-insured" their home mortgage originations during past periods. These lenders charged and retained a "risk premium" in the form of slightly higher interest rates as the price for assuming higher risks associated with lower margin money requirements. In the longer run, mortgage insurance written by an independent third party typically has conferred benefits not achievable through self-insurance, i.e., formal recognition by secondary investors and regulators, a genuine transfer and sharing of risk, and in some cases, capital relief.

Comparing third-party default insurance with self-insurance also helps to illustrate what mortgage insurance does <u>not</u> do, i.e., it does not make "bad" loans "good" or provide license for undisciplined underwriting. Rather, mortgage insurance allows carefully prescribed incremental risks to be evaluated, assumed and responsibly managed.

VII. Actuarial Considerations

It is possible to create a progm that guaranties mortgage repayment in the event of borrower default *without* actuarial analysis. Such guaranty programs exist outside India; they are typically government sponsored and offered as an adjunct to a housing subsidy program. Such programs are not "insurance" *per se* because they do not involve the establishment of risk-based premiums or risk-based reserves. A government agency in India could conceivably offer such a program, but it would be inconsistent with the nation's move toward a market-driven economy. This type of non-insurance guaranty is discussed in Appendix L.

Actuarial soundness will be a fundamental requirement for any well-conceived mortgage insurance program for India. Prescribing what constitutes an actuarially sound MI program – a difficult task under any circumstances – will be especially challenging in India. Measuring and predicting mortgage default risk is inherently imprecise: the risk covered by a premium charge on an insured home loan originated now will extend many years into the future. Furthermore, the major risk variables affecting borrower repayment patterns and property value trends are subject not only to economic vagaries, but to conscious public policy shifts that are unforeseeable when the risk is assumed. For example, 1986 tax reforms in the U.S. reduced the investment attractiveness of residential real estate, causing the value of many residential resort and rental condominiums to plummet. Many mortgage insurance claims resulted.

The difficulties of predicting insurance losses for a *de novo* MI in India are compounded by the lack of consistent or reliable data on mortgage defaults and losses. What limited data does exist is not useful for structuring prospective mortgage insurance premiums because: (1) the experience period, limited to the history of the oldest and largest HFC, does not include a full cycle of rising and falling economic activity and home prices; and (2) recorded delinquency data tends to be limited to arrearages, rather than write-offs. Consequently, we have no usable loss experience data involving unresolved delinquencies from which to project either claims incidence or loss severity.

The paucity of mortgage risk experience data, while problematic, need not prevent the launching of a mortgage default insurance program if other essential ingredients favorable to such an initiative are present. Key risk and financial assumptions may be extrapolated from general experience in countries where more recorded data is available. Care must be taken, however, to take proper account of risk-related circumstances that may be unique to the Indian housing situation and, where in doubt, to err on the side of conservatism. Once a new MI program becomes operational in India, should risk experience then evolve more favorably than projected, progressive premium reductions could then be justified.

A financial guaranty that is marketed to financial institutions may be one of the most difficult products to offer in terms of securing threshold credibility from those who will rely upon it. Therefore, even the most conservative approach to undertaking a new, private-sector MI program may run into difficulties achieving market acceptance. For this reason, a mortgage default

insurer's initial startup phase in India may require some form of government backstop during the earliest years of operation.

The remainder of this section uses a simple MI pricing model to illustrate how certain key variables are used to develop a required pricing level for a hypothetical mortgage insurance program in India. The baseline assumptions for rate-making purposes include loss factors that far exceed those actually experienced in India to date, because:

- Mortgage insurance must be premised upon significant, periodic fluctuations in economic conditions, including property values, and economic recessions more severe than any occurring in recent memory.
- The very purpose of mortgage insurance is to induce lender acceptance of risks greater than those previously assumed without benefit of mortgage insurance protection.
- Credibility is the key to viability. In the absence of actual loss experience, initial risk assumptions must be highly conservative in order to pass muster with insurance regulators, rating agencies, policyholders, and investors.

Financial and operating assumptions needed to establish a basic, actuarially sound model for a potential mortgage insurance undertaking in India include at minimum the following:

- Average loan size
- Insurance coverage as a percent of loan amount
- Exposure "runoff" factors, i.e., amortization, prepayments, and cancellations combined
- Stipulated premium rate
- Premium earnoff factors
- Total claim incidence (percent of loan insured) over the life of a group of policies written during a given period
- Timing of claims incidence over life of policy
- Average loss severity (amount of loss per claim)
- Timing of loss recognition (loss reserve allocation) versus actual claim payment
- Capital reserve requirements (percent of risk outstanding and/or premium earned)
- Overhead/operating cost factors, including timing over policy life
- Rate of return on invested assets
- Corporate tax rate

In evaluating the feasibility of a privately capitalized mortgage insurer (as opposed to the type of non-insurance guaranty discussed in Appendix L), the key driver in the model is the required rate of return (after tax) on invested capital. A prospective government-sponsored MI might require only that the rate of return not be negative. In either case, the key relationship, given all the other financial and operating assumptions as input, is the indicated relationship between any given premium rate and various financial outcomes, as expressed by the single measure of rate of return on capital.

Tables 1A through 10A on the pages immediately following illustrate how a hypothetical MI program might perform, using reasonable assumptions for the Indian context. Key assumptions are summarized as follows:

- Average loan amount: 2 lakhs
- Insurance coverage as a percent of loan amount: first 25 percent
- Exposure "persistence" factor: annual "runoff rate" = 10 percent
- Stipulated premium rate: a single prepaid premium equal to 2.3 percent of the original loan amount
- Premium earnoff factor: first year = 50 percent of initial premium payment; 5 percent annually thereafter
- Total claims incidence over life of policy: 4 percent
- Timing of claims incidence: spread over eight years with peak incidence in the fourth year
- Average loss severity (amount per claim): 25 percent of original loan amount
- Timing of loss recognition: loss reserve booked one year prior to claim paid
- Capital reserve requirement: minimum reserves = 5 percent of risk outstanding
- Catastrophic reserve requirement: one-half of earned premium allocated to long term catastrophic loss reserve, which is counted as part of overall capital reserves
- Operating cost factor (overhead): total = 30 percent of premium written with 1/2 attributable to year one and the balance spread evenly over ten years
- Annual rate of return on invested assets: 10 percent
- Corporate tax rate (non-government program): 45 percent
- Internal rate of return on investment capital : 15 percent

In order to illustrate the costly effects of inefficient or inoperative foreclosure laws, an alternative performance example is developed in Tables 1B to 10B. In this instance, all assumptions remain the same as in Tables 1A to 10A, except that exceedingly long foreclosure periods are translated

into a much higher loss severity factor – 50 percent instead of 25 percent, together with a corresponding increase in policy coverage from 25 to 50 percent. This added average loss per claim is intended to approximate (and probably understates) the extra unpaid interest and legal costs that would occur when foreclosure proceedings extend for many years instead of one year or less, as is prevalent in most countries where mortgage insurance appears to work well.

The key finding from this second "long foreclosure" illustration is that, to achieve a 15 percent rate of return equivalent to that of the first, "efficient foreclosure" example, the premium rate must be increased from 2.3 percent to 3.9 percent to cover the added cost of insuring multiyear foreclosures. Of course, this illustration represents only a rough approximation. A more accurate depiction would need to simulate specific coverage terms, including a partial claims payout schedule during an extended foreclosure proceeding, as well as the time value of money.

Each financial table is briefly described below.

Tables 1A & B – Baseline Assumptions set forth the basic product description, including average loan amount, premium rate, claims incidence and severity, investment and tax rates, and key reserve parameters. In processing these inputs, the model depicts the essential relationship between any given premium rate and resulting after-tax rates of return. In the examples shown, prepaid premium rates of 2.3 and 3.9 percent of the original loan amount respectively, subject to all operating assumptions noted, generate a rate of return of 15.0 percent.

Tables 2A & B – Risk and Runoff show an annual 10 percent reduction, or runoff, of insurance risk exposure year-to-year. Risk exposure is defined as the total "insurance in force," or insured loan amount multiplied by the percent coverage, which, in this example is 25 percent.

Tables 3 A & B– Cash Revenues show total cash revenues as the sum of premiums received plus investment income, which, in this example, equals 10 percent annual return on total assets.

Tables 4 A & B– Cash Costs show total cash costs, which, in this basic model, simply equals total overhead, allocated by year as described above. Corporate taxes are deducted at the end.

Tables 5A & B – Cash Claims Losses develop total annual claim payments as a function of total original insurance written multiplied by the applicable claims incidence factor (a "bell-shaped curve" that peaks in the fourth year), then multiplied by the loss severity factor, here assumed to equal 25 and 50 percent respectively, of the original loan amount.

Tables 6A & B – Non-Cash Adjustments illustrate accounting adjustments which are essential to the subsequent determination of policyholders reserve requirements. "Adjusted revenues" equal the sum of earned (rather than written) premiums and interest income as shown in Tables 3A and 3B. "Adjusted costs and losses" include not only claims paid and allocated overhead, as already shown, but also additions to the loss reserve that are equal to the amount of claims to be paid in the following year as shown in Tables 5A and 5B.

Tables 7A & B – Reserves are somewhat more complex. The second and third columns show the building of a long-term contingency reserve through the allocation and retention of one-half

of each year's earned premium. In these simplified illustrations, which are based on only one original year of new insurance written, the contingency reserve peaks in the tenth year and then starts to run off. In an ongoing operation, with successive years of new insurance being written, the contingency reserve would be drawn down only in the event of severe recession.

"Minimum capital required" in the fourth column is determined as the greater of "policyholders reserve" in column one and "contingency reserve" in column three. "Policyholders reserve" is computed as a minimum percentage of total insurance exposure – in this example, five percent, which is equivalent to a 20-to-1 risk-to-reserve ratio.

The loss reserve, drawn from the Tables 6A and 6B, is simply the total amount of claims to be paid in each subsequent year. The unearned premium reserve equals the difference between total premium collected and portion of premium collected that has already been earned. Total statutory reserves equals the sum of loss reserves, unearned premium reserves, and "minimum capital required" as defined above.

Tables 8A & B – Assets Under the assumptions used in these examples, "total assets required" are equal to "total statutory reserves" required in Table 7. Under a different set of assumptions, however, whereby an investment rating agency would impose more stringent reserve ratios than an insurance regulator, "required assets" (Table 8) would exceed "required statutory reserves" (Table 7). Under such a scenario, the indicated rate of return on invested capital would also be reduced.

Tables 9A & B – Accounting Summary bring net revenues and costs and claims from Tables 6A and 6B, the difference of which equals the pretax profit (or loss in the early years). The 45 percent tax rate stipulated in Tables 1A and 1B is then applied to produce net after-tax profit, which, in turn, is measured against assets invested each year to generate annual return on average assets.

Tables 10A & B– Cash Flow Summary summarize all annual cash flows – set forth in Tables 3Aand 3B, 4A and 4B, 5A and 5B, and 9A and 9B – as the basis for generating an internal rate of return on invested assets, which, in both examples, amounts to 15.0 percent.

Table 1-A

BASELINE ASSUMPTIONS

Average loan amount	200,000
Coverage	25%
Cumulative claim rate	4.0%
Loss severity	25.0%
Investment interest rate	10.0%
Policy overhead	1,500
Risk to capital ratio	20
Income tax rate	45.0%
Premium tax rate	0.0%
Policyholder reserve rate	5.00%
INTERNAL RATE OF RETURN	15.0%

PRICE:	BP
Year1	230
Year2	0
Year3	0
Year4	0
Year5	0
Year6	0
Year7	0
Year8	0
Year9	0
Year10	0
Year11	0
Year12	0

Table 1-B

BASELINE ASSUMPTIONS

Average loan amount	$200,000
Coverage	50%
Cumulative claim rate	4.0%
Loss severity	50.0%
Investment interest rate	10.0%
Policy overhead	$1,500
Risk to capital ratio	20
Income tax rate	45.0%
Premium tax rate	0.0%
Policyholder reserve rate	5.00%
INTERNAL RATE OF RETURN	15.0%

PRICE:	BP
Year1	390
Year2	0
Year3	0
Year4	0
Year5	0
Year6	0
Year7	0
Year8	0
Year9	0
Year10	0
Year11	0
Year12	0

Table 2-A

RISK & RUNOFF

YEAR	RUNOFF RATE	ORIGINAL AMOUNT INSURED	NEGATIVE AMORT FACTOR	RISK	INSURANCE IN FORCE
1	1.0	200,000	1.00	50,000	200,000
2	0.9	200,000	1.00	45,000	180,000
3	0.8	200,000	1.00	40,000	160,000
4	0.7	200,000	1.00	35,000	140,000
5	0.6	200,000	1.00	30,000	120,000
6	0.5	200,000	1.00	25,000	100,000
7	0.4	200,000	1.00	20,000	80,000
8	0.3	200,000	1.00	15,000	60,000
9	0.2	200,000	1.00	10,000	40,000
10	0.1	200,000	1.00	5,000	20,000
11	0.0	200,000	1.00	0	0
12	0.0	200,000	1.00	0	0

Table 2-B

RISK & RUNOFF

YEAR	RUNOFF RATE	ORIGINAL AMOUNT INSURED	NEGATIVE AMORT FACTOR	RISK	INSURANCE IN FORCE
1	1.0	200,000	1.00	100,000	200,000
2	0.9	200,000	1.00	90,000	180,000
3	0.8	200,000	1.00	80,000	160,000
4	0.7	200,000	1.00	70,000	140,000
5	0.6	200,000	1.00	60,000	120,000
6	0.5	200,000	1.00	50,000	100,000
7	0.4	200,000	1.00	40,000	80,000
8	0.3	200,000	1.00	30,000	60,000
9	0.2	200,000	1.00	20,000	40,000
10	0.1	200,000	1.00	10,000	20,000
11	0.0	200,000	1.00	0	0
12	0.0	200,000	1.00	0	0

Table 3-A

CASH REVENUES

YEAR	GROSS PREMIUMS	REINSURANCE PRICING	REINSURANCE PREMIUMS	NET PREMIUMS	OTHER REVENUE	INTEREST INCOME	NET CASH REVENUE
1	4600	0	0	4600		255	4855
2	0	0	0	0		501	501
3	0	0	0	0		461	461
4	0	0	0	0		398	398
5	0	0	0	0		341	341
6	0	0	0	0		305	305
7	0	0	0	0		288	288
8	0	0	0	0		273	273
9	0	0	0	0		261	261
10	0	0	0	0		249	249
11	0	0	0	0		173	173
12	0	0	0	0		98	98

Table 3-B

CASH REVENUES

YEAR	GROSS PREMIUMS	REINSURANCE PRICING	REINSURANCE PREMIUMS	NET PREMIUMS	OTHER REVENUE	INTEREST INCOME	NET CASH REVENUE
1	7800	0	0	7800		475	8275
2	0	0	0	0		936	936
3	0	0	0	0		863	863
4	0	0	0	0		744	744
5	0	0	0	0		625	625
6	0	0	0	0		535	535
7	0	0	0	0		490	490
8	0	0	0	0		464	464
9	0	0	0	0		443	443
10	0	0	0	0		422	422
11	0	0	0	0		294	294
12	0	0	0	0		166	166

Table 4-A

CASH COSTS

YEAR	OVERHEAD FORMULA	OVERHEAD ALLOCATED	OTHER COSTS	PREMIUM TAXES	TOTAL COSTS
1	0.50	750		0	750
2	0.05	75		0	75
3	0.05	75		0	75
4	0.05	75		0	75
5	0.05	75		0	75
6	0.05	75		0	75
7	0.05	75		0	75
8	0.05	75		0	75
9	0.05	75		0	75
10	0.05	75		0	75
11		0		0	0
12		0		0	0

Table 4-B

CASH COSTS

YEAR	OVERHEAD FORMULA	OVERHEAD ALLOCATED	OTHER COSTS	PREMIUM TAXES	TOTAL COSTS
1	0.50	750		0	750
2	0.05	75		0	75
3	0.05	75		0	75
4	0.05	75		0	75
5	0.05	75		0	75
6	0.05	75		0	75
7	0.05	75		0	75
8	0.05	75		0	75
9	0.05	75		0	75
10	0.05	75		0	75
11		0		0	0
12		0		0	0

Table 5-A

CASH CLAIM LOSSES

YEAR	TOTAL INSURED	NET AMT INSURED	CLAIM INCIDENCE	CLAIM SEVERITY	CLAIMS LOSSES	OTHER LOSS EXPENSE	TOTAL CASH LOSS EXPENSE
1	200,000	200,000	0.02%	0.25	10		10
2	200,000	200,000	0.60%	0.25	300		300
3	200,000	200,000	1.20%	0.25	600		600
4	200,000	200,000	0.92%	0.25	460		460
5	200,000	200,000	0.60%	0.25	300		300
6	200,000	200,000	0.32%	0.25	160		160
7	200,000	200,000	0.16%	0.25	80		80
8	200,000	200,000	0.08%	0.25	40		40
9	200,000	200,000	0.04%	0.25	20		20
10	200,000	200,000	0.04%	0.25	20		20
11	200,000	200,000	0.02%	0.25	10		10
12	200,000	200,000	0.00%	0.25	0		0

Table 5-B

CASH CLAIM LOSSES

YEAR	TOTAL INSURED	NET AMT INSURED	CLAIM INCIDENCE	CLAIM SEVERITY	CLAIMS LOSSES	OTHER LOSS EXPENSE	TOTAL CASH LOSS EXPENSE
1	200,000	200,000	0.02%	0.50	20		20
2	200,000	200,000	0.60%	0.50	600		600
3	200,000	200,000	1.20%	0.50	1200		1200
4	200,000	200,000	0.92%	0.50	920		920
5	200,000	200,000	0.60%	0.50	600		600
6	200,000	200,000	0.32%	0.50	320		320
7	200,000	200,000	0.16%	0.50	160		160
8	200,000	200,000	0.08%	0.50	80		80
9	200,000	200,000	0.04%	0.50	40		40
10	200,000	200,000	0.04%	0.50	40		40
11	200,000	200,000	0.02%	0.50	20		20
12	200,000	200,000	0.00%	0.50	0		0

Table 6-A

NON-CASH ADJUSTMENTS

YEAR	EARNED PREMIUMS	ADDITION TO LOSS RESERVE	ADJUSTED REVENUES	ADJUSTED COSTS & LOSSES
1	2300	300	2555	1060
2	230	600	731	675
3	230	460	691	535
4	230	300	628	375
5	230	160	571	235
6	230	80	535	155
7	230	40	518	115
8	230	20	503	95
9	230	20	491	95
10	230	10	479	85
11	0	0	173	0
12	0	0	98	0

Table 6-B

NON-CASH ADJUSTMENTS

YEAR	EARNED PREMIUMS	ADDITION TO LOSS RESERVE	ADJUSTED REVENUES	ADJUSTED COSTS & LOSSES
1	3900	600	4375	1370
2	390	1200	1326	1275
3	390	920	1253	995
4	390	600	1134	675
5	390	320	1015	395
6	390	160	925	235
7	390	80	880	155
8	390	40	854	115
9	390	40	833	115
10	390	20	812	95
11	0	0	294	0
12	0	0	166	0

Table 7-A

RESERVES

YEAR	POLICY HOLDERS RESERVE	1/2 of EARNED PREMIUMS	CONTIN-GENCY RESERVE	MINIMUM CAPITAL REQUIRED	LOSS RESERVE	UNEARNED PREMIUM RESERVE	TOTAL REQUIRED RESERVES
1	2500	1150	1150	2500	300	2300	5100
2	2250	115	1265	2250	600	2070	4920
3	2000	115	1380	2000	460	1840	4300
4	1750	115	1495	1750	300	1610	3660
5	1500	115	1610	1610	160	1380	3150
6	1250	115	1725	1725	80	1150	2955
7	1000	115	1840	1840	40	920	2800
8	750	115	1955	1955	20	690	2665
9	500	115	2070	2070	20	460	2550
10	250	115	2185	2185	10	230	2425
11	0	0	1035	1035	0	0	1035
12	0	0	920	920	0	0	920

Table 7-B

RESERVES

YEAR	POLICY HOLDERS RESERVE	1/2 of EARNED PREMIUMS	CONTIN-GENCY RESERVE	MINIMUM CAPITAL REQUIRED	LOSS RESERVE	UNEARNED PREMIUM RESERVE	TOTAL REQUIRED RESERVES
1	5000	1950	1950	5000	600	3900	9500
2	4500	195	2145	4500	1200	3510	9210
3	4000	195	2340	4000	920	3120	8040
4	3500	195	2535	3500	600	2730	6830
5	3000	195	2730	3000	320	2340	5660
6	2500	195	2925	2925	160	1950	5035
7	2000	195	3120	3120	80	1560	4760
8	1500	195	3315	3315	40	1170	4525
9	1000	195	3510	3510	40	780	4330
10	500	195	3705	3705	20	390	4115
11	0	0	1755	1755	0	0	1755
12	0	0	1560	1560	0	0	1560

Table 8-A

ASSETS

YEAR	MIN.RISK CAPITAL REQUIRED	UNEARNED & LOSS RESERVES	TOTAL CAPITAL REQUIRED	TOTAL RESERVES REQUIRED	TOTAL ASSETS REQUIRED
1	2500	2600	5100	5100	5100
2	2250	2670	4920	4920	4920
3	2000	2300	4300	4300	4300
4	1750	1910	3660	3660	3660
5	1500	1540	3040	3150	3150
6	1250	1230	2480	2955	2955
7	1000	960	1960	2800	2800
8	750	710	1460	2665	2665
9	500	480	980	2550	2550
10	250	240	490	2425	2425
11	0	0	0	1035	1035
12	0	0	0	920	920

Table 8-B

ASSETS

YEAR	MIN.RISK CAPITAL REQUIRED	UNEARNED & LOSS RESERVES	TOTAL CAPITAL REQUIRED	TOTAL RESERVES REQUIRED	TOTAL ASSETS REQUIRED
1	5000	4500	9500	9500	9500
2	4500	4710	9210	9210	9210
3	4000	4040	8040	8040	8040
4	3500	3330	6830	6830	6830
5	3000	2660	5660	5660	5660
6	2500	2110	4610	5035	5035
7	2000	1640	3640	4760	4760
8	1500	1210	2710	4525	4525
9	1000	820	1820	4330	4330
10	500	410	910	4115	4115
11	0	0	0	1755	1755
12	0	0	0	1560	1560

Table 9-A

ACCOUNTING SUMMARY

YEAR	NET REVENUES	COSTS & CLAIMS	INCOME TAXES	NET PROFIT	ASSETS INVESTED	RETURN ON AVERAGE ASSETS
1	6195	1680	2032	2483	13900	35.7%
2	1920	1875	20	25	13500	0.2%
3	1814	1455	162	197	11780	1.6%
4	1639	975	299	365	10000	3.4%
5	1464	555	409	500	8280	5.5%
6	1320	315	452	553	7115	7.2%
7	1242	195	471	576	6720	8.3%
8	1205	135	482	589	6385	9.0%
9	1175	135	468	572	6110	9.2%
10	1146	105	468	572	5805	9.6%
11	414	0	186	228	2475	5.5%
12	234	0	105	129	2200	5.5%

Table 9-B

ACCOUNTING SUMMARY

YEAR	NET REVENUES	COSTS & CLAIMS	INCOME TAXES	NET PROFIT	ASSETS INVESTED	RETURN ON AVERAGE ASSETS
1	4375	1370	1352	1653	9500	34.8%
2	1326	1275	23	28	9210	0.3%
3	1253	995	116	142	8040	1.6%
4	1134	675	206	252	6830	3.4%
5	1015	395	279	341	5660	5.5%
6	925	235	310	379	5035	7.1%
7	880	155	326	399	4760	8.1%
8	854	115	333	407	4525	8.8%
9	833	115	323	395	4330	8.9%
10	812	95	323	394	4115	9.3%
11	294	0	132	161	1755	5.5%
12	166	0	75	91	1560	5.5%

Table 10-A

CASHFLOW SUMMARY

internal rate of return: 15.0%

YEAR	NET CASH REVENUES	CASH EXPENSES	INCOME TAXES	CASH INCOME	ASSET CHANGE	TOTAL CASHFLOW
1	11695	780	2032	8883	-13900	-5017
2	1370	975	20	375	400	775
3	1264	1875	162	-773	1720	947
4	1089	1455	299	-665	1780	1115
5	914	975	409	-470	1720	1250
6	770	555	452	-237	1165	928
7	692	315	471	-94	395	301
8	655	195	482	-21	335	314
9	625	135	468	22	275	297
10	596	135	468	-8	305	297
11	414	30	186	198	3330	3528
12	234	0	105	129	275	404

Table 10-B

CASHFLOW SUMMARY

internal rate of return: 15.0%

YEAR	NET CASH REVENUES	CASH EXPENSES	INCOME TAXES	CASH INCOME	ASSET CHANGE	TOTAL CASHFLOW
1	8275	770	1352	6153	-9500	-3347
2	936	675	23	238	290	528
3	863	1275	116	-528	1170	642
4	744	995	206	-458	1210	752
5	625	675	279	-329	1170	841
6	535	395	310	-171	625	454
7	490	235	326	-71	275	204
8	464	155	333	-23	235	212
9	443	115	323	5	195	200
10	422	115	323	-16	215	199
11	294	20	132	141	2360	2501
12	166	0	75	91	195	286

VIII. Potential Increase in Mortgage Lending Attributable to Mortgage Insurance

Mortgage insurance, *by itself*, can expand the volume of lending to first time homeowners, but only through the incremental relaxation of certain underwriting standards. Because MI alone is neither a subsidy, a fresh source of capital, nor a substitute for responsible underwriting by competent, experienced lenders, dramatic increases in total lending volume should not be expected solely as a result of mortgage insurance availability. With that caveat, an inquiry into what benefits might realistically be achieved yields the following tentative results.

India's housing finance companies during the most recent reporting year extended mortgage loans for housing approximately Rs. 2330 crores. Since the residential lending volume of the leading half dozen HFCs constitutes about 90 percent of the "formal" market for housing loans, this lead group would have loaned about Rs. 2100 crores secured by housing. Of this total, about 25 percent went to corporate borrowers (e.g., employers, builders, coops), leaving an estimated Rs. 1575 crores going directly to individual borrowers for home purchase financing. Assuming an average loan size of Rs. 110,000 to 130,000, the total number of households financing a 1995 home purchase through one of the leading HFCs would be roughly 130,000.

Hard data that would further segment the total residential market by borrower income does not appear to be available. However, discussions with HFC managers suggest that about 5 to 10 percent of all borrowers financing their home purchase through a leading HFC fall below the national median income, estimated at Rs. 40,000 per year. This percentage range translates into about 10,000 below-median-income borrowers in 1995.

Unfortunately, the proportion of below-median-income borrowers served by HFCs appears to be not only low, but declining. The reason is simple: home prices have been rising faster than personal income throughout much of India, especially in urban areas. What is already a serious affordability issue for moderate income households threatens to become more aggravated in the near term.

Mortgage default insurance offers an excellent, though modest, tool to help alleviate this growing affordability crisis. The following example, based on discussions with HFC lenders, serves to illustrate how MI would increase affordability in India's current market environment by nearly 15 percent.

Assume the following situation:

Prospective borrower's annual income	Rs. 36,000
monthly income	Rs. 3,000
Prospective home price	Rs.150,000
Margin money available (after loan origination cost)	Rs. 65,000
Required HFC financing	Rs. 85,000
Prospective monthly payment (15% rate, 15-yr term = 14 Rs./1,000 loan amount)	Rs. 1,190
Lenders IIR limit without mortgage insurance	35%
Lenders IIR limit with mortgage insurance	40%
Affordable monthly payment without mortgage insurance	Rs. 1,050
Affordable monthly payment with mortgage insurance	Rs. 1,200
Affordable loan amount without mortgage insurance	Rs. 75,000
Affordable loan amount with mortgage insurance	Rs. 85,700

In the above-described situation, mortgage insurance clearly enhances affordability. Whether measured by monthly payment (Rs. 1200 vs. Rs. 1050) or by loan amount (Rs. 85,700 vs. Rs.75,000), the affordability increment in this illustration amounts to about 14 percent.

For underwriting purposes in this simplified example, the mortgage lender relies upon mortgage insurance protection to extend its established IIR limit by five percentage points. In other words, whatever IIR limit would have been imposed for a particular applicant – and that would vary case by case – the "uninsured IIR" could be increased by five percentage points. A borrower-paid mortgage insurance premium covers the incremental risk that would otherwise have resulted in a probable loan denial.

The added cost of insurance borne by the borrower, while not insignificant, would be affordable insofar as it could be financed as part of the total (insured) loan amount. Applying the prospective premium rates set forth in Section VII above, the cost of mortgage insurance in the above situation would be approximately as follows:

	MI Premium Rate	MI Premium Amount	Incremental Monthly Premium
Current foreclosure system	3.90%	Rs. 3342	Rs. 50
Efficient foreclosure system	2.30%	Rs. 1971	Rs. 30

The extent to which mortgage insurance, by itself, would expand lending volume for below-median-income households would depend primarily upon the income distribution curve. In other words, how many prospective home purchasers fall within the "14 percent incremental affordability band"?

There is no firm answer to this question. However, because the current *share* of below-median-income lending is so low, the *proportionate,* if not the absolute, increase attributable to mortgage insurance availability could be considerable. For the purposes of illustration, assume a below-median population being served of about 10,000 households annually. By extending affordability parameters in the manner shown for prospective homeowners currently "at the margin", mortgage insurance might double this population. Furthermore, whatever absolute increase may be achievable in the near term should then also track at an annual growth rate commensurate with the growth of the market as a whole – currently an estimated 25 percent.

The relationship between mortgage insurance and housing affordability must be considered in a larger context. To confront the affordability challenge requires addressing *all* cost factors that comprise, first, both the financing and the "bricks and mortar" aspects of the housing delivery system, and second – equally critical – people's real incomes and buying power. In this broader context, mortgage default insurance is a small, but potentially worthwhile, component.

Mortgage insurance can induce primary market lenders to loan more funds on somewhat more affordable terms. But if an adequate flow of properly matched funds is not available through institutional lenders, the benefits solely attributable to instituting a primary MI program will be limited. In order to optimize the affordability benefits achievable from primary MI, it is also necessary to take action on closely related fronts such as:

- Foreclosure reform
- Transaction cost reduction
- Land regulation reform
- HFC deposit insurance
- Secondary market funding sources

Beyond enhancing affordability directly, the development of mortgage insurance for the primary market will expedite the creation of a secondary market for two reasons. First, the institutional framework for standardization and third-party loan quality review – both essential for secondary market – will be in place. Second, mortgage insurance as an established form of "credit enhancement" can, in modified form, help give institutional investors the necessary confidence to shift investable funds from other non-housing debt instruments into mortgage-related investments.

IX. Findings and Recommendations

This section first sets forth general findings regarding how mortgage insurance in India might help meet the nation's housing goals in the context of a deregulating economy and a privatizing financial sector. Specific recommendations which follow include possible actions and roles of the National Housing Bank and India's Housing Finance Corporations.

Findings

Both the retail mortgage lending sector and the general insurance environment appear to be conducive in the relative near term – though not immediately – to the development of a viable mortgage insurance program.

Expanded Lending and Homeownership

As India's financial markets deregulate and privatize, mortgage default insurance should be able to evolve as a useful adjunct to the nation's home mortgage financing system. Initially, mortgage insurance can help expand the universe of potential first-time home buyers who qualify for financing ("primary market"). Subsequently, mortgage insurance can help increase the flow of institutional capital into home mortgages via mortgage-backed investment instruments ("secondary market").

By inducing moderately relaxed underwriting limits, mortgage insurance should enable the leading HFCs to make homeownership possible for 10,000 or more additional below-median-income households nationwide each year. Once mortgage insurance becomes an accepted part of the market for home financing, the number of additional first-time buyers reached through MI should grow at least as rapidly as the overall market. Of course, even such modest benefits depend upon HFCs having adequate funding sources from which to increase lending value by the desired amounts.

Mortgage insurance should also help approved lenders to reach other currently unserved and underserved segments of the market. Two such clearly identifiable sectors are those self-employed persons who, with better income documentation, could qualify, and salaried persons whose source of income is currently viewed by lenders as insufficiently stable. There is at present, however, no practical way to gauge the probable size or share of this potential market that can feasibly be underwritten by using MI as a risk management tool.

Foreclosure System Reforms

As a form of credit enhancement that guarantees repayment of a loan collateralized by housing, mortgage default insurance relies on the ability to recover the pledged collateral in the event of default. The emergence of mortgage insurance in India in the near term will be seriously impeded – though not necessarily prevented – in the absence of legal and political reforms that result in a working foreclosure system.

Efforts to launch a program of mortgage insurance should not be deferred because of problems with the current, dysfunctional foreclosure system. At worst, any MI product offered and accepted in the short run will suffer from excessive costs attributable to the lender's and insurer's inability to mitigate claims losses through collateral recovery and resale. If even a single jurisdiction were to enact and implement genuine foreclosure reforms, the resultant reduced costs of mortgage insurance and financing will translate into expanded homeownership opportunities. Should such benefits then become apparent to other jurisdictions, further reforms may follow.

These observations also apply to the very high transactions costs attributable to property transfer fees and documentation registration costs. The effect of reduced transaction costs on the cost and feasibility of mortgage insurance would be far less than the benefits of foreclosure reforms, however.

The tentative finding that mortgage insurance should be feasible to implement in the face of current foreclosure obstacles and excessive transaction costs needs to be tested further in the emerging marketplace. While the potential benefits of mortgage insurance are recognized by thoughtful market participants, there remains the possibility that a self-sustaining mortgage insurance program would have to be priced to high that borrowers and lenders would judge the MI's indicated benefits to be not worth its required cost. In this instance, one of two eventual positive outcomes might still emerge:

1. The recognized public policy benefits associated with increased housing affordability might result in some form of government financial support for an early MI launching, pending subsequent resolution of difficulties relating to foreclosure laws and transaction costs.
2. MI implementation might be deferred until evolving market forces bring sufficient pressures to bear – possibly one state at a time – producing foreclosure and transaction cost reforms.

Pricing and Risk

In the absence of reliable domestic experience data relating to home mortgage default frequency and loss severity, initial pricing of a new MI product in India should be based on conservative estimates of claims incidence and severity. Such conservatism will be limited by "what the markets will bear" in terms of offered premium rates, particularly because premiums will be borrower-paid – either directly or indirectly – while increased borrower affordability is an essential feature of the product. If this balance is not properly cast, the MI will fail either from excessive premium rates or excessive losses.

Recommendations

National Housing Bank

NHB will occupy a central position in initiating any form of viable mortgage default insurance in India, be it publicly or privately sponsored or some combination. Conversely, mortgage insurance offers a potent tool, in combination with other actions, for NHB to accomplish some of

its major goals. NHB can spur constructive progress through a combination of lobbying efforts within the government, legislative initiatives, research and development work, provision of backup financial support, promulgation of standards, and wise exercise of regulatory oversight. Specific recommendations include the following:

- NHB should mobilize its various resources to support the evolution of a soundly conceived domestic mortgage insurance scheme. Such a scheme initially will directly reinforce the workings of the primary mortgage market. Over time, it will also add depth to an emerging secondary mortgage market.

- NHB should monitor developments in the emerging insurance sector and encourage the development of legal and regulatory measures conducive to developing a sound mortgage default insurance framework that serve the needs of qualified HFCs. In particular, NHB should encourage the establishment of:

  - Special rules governing mortgage insurance within the larger framework developed for general (P&C) insurance lines

  - An effective regulatory body (not necessarily NHB itself) to govern mortgage insurer safety and soundness.

- NHB should press for early and effective foreclosure reforms for both primary and secondary mortgage markets. In addition to seeking reform legislation at the national level, NHB should be alert to conditions in individual states that may make them good candidates for foreclosure reform. Such reforms could then serve as a models for broader application.

  - Reasonable foreclosure reform should enable lenders under normal circumstances to recover clear title and possession to collateral property within one year or less following borrower default.

  - Once a collateral property is recovered, there should be no further right of redemption by the defaulting borrower, although the borrower should retain rights to any net proceeds exceeding the amount of the outstanding debt.

  - Any foreclosure reform should apply to all mortgage loans extended by all institutional lenders; no segment of the market should be afforded favorable treatment.

- NHB should study various means by which it might issue a standby or backup default guaranty covering catastrophic and political risk only. Such a guaranty would:

  - Offer implied government support, thereby further increasing the attractiveness and lowering the cost of insured mortgage instruments

  - Back up privately insured risk exposure on HFC loans held in portfolio, but only in the event of private insurer insolvency

  - Eventually attach to pools of rated, securitized loans sold in the secondary market. An NHB guaranty for securitized mortgage pools should stand behind some other form of credit enhancement, e.g., private insurance, overcollateralization, senior-subordinated structured financing, or private guaranty by an institutional issuer.

- NHB should encourage qualified HFCs to collaborate in the formation of a strongly capitalized, highly rated insurance carrier for the express purpose of writing mortgage default insurance.

- NHB should continue to strengthen its oversight of the safety and soundness of HFCs, while allowing reasonable latitude for healthy experimentation by regulated HFCs in the emerging private marketplace for home mortgages.

- NHB should establish standardized HFC reporting relative to mortgage origination and servicing performance, including delinquency and default experience.

- NHB should work with an HFC industry group to develop standardized underwriting documentation, along with a workable definition of a fixed rate "conforming loan" for securitization purposes and a variable rate "conforming loan," primarily for ratable portfolio lending by privately rated lending institutions. The leading rating agencies might be invited to participate in this effort.

- NHB need neither wait for, nor rely upon the development or availability of mortgage default insurance as a prerequisite to its plans for mortgage securitization. Credit enhancement for securitized pools is essential. However, mortgage insurance (in the form of mortgage pool insurance) is only one – and probably not the best or most cost-effective – form of credit enhancement for mortgage-backed securities. Over-collateralization or senior-subordinated structured financing may be preferable types of credit enhancement for India's pilot mortgage-backed securities program. The subject of credit enhancements for securitized mortgage pools is addressed in a comparison report also commissioned by the Indo-U.S. Housing Finance Expansion Project.)

Housing Finance Companies

HFCs stand to be the prime users and beneficiaries of any mortgage insurance program launched in India – whether government or private. As a result, HFCs have a stake in every aspect of mortgage insurance development, from authorizing legislation and regulations, to capitalization and control, to program design and cost. The following recommendations address the interests of HFCs in mortgage insurance implementation.

- HFCs should seek an active voice in the insurance deregulation process to assure the establishment of a viable framework for mortgage default insurance in India.

- HFCs should develop, in advance, improved data collection and performance reporting systems in order to provide further insight into the causes and characteristics of mortgage default risk.

- HFCs should explore the feasibility of capitalizing a jointly sponsored and owned insuring entity to provide mortgage default insurance to its owners and, possibly later on, to other non-sponsoring mortgage lenders. NHB support should be sought in this endeavor, including possible capital backing, but private stockholder majority control should be retained.

- HFCs should consider forming an industry trade association to advance their common interests (while not dampening their competitive energies), including:
  - Development of an industry-sponsored mortgage insurer
  - Foreclosure reforms and reduction of stamp duties
  - Collaboration with progressive state governments and HUDCO to promote the financing of affordable housing for lower income buyers
  - Development of current, useful data on local and regional housing markets and encouragement of appropriate government agencies to undertake similar efforts
  - Construction of productive industry-level relationships with NHB, RBI, HUDCO, state agencies, and the new insurance sector regulator
  - Collaboration with NHB, rating agencies, and international players to develop a working secondary mortgage market
- Although the largest few HFCs may operate on a large enough scale, both geographically and in terms of loan volume, to consider "self-insuring", this alternative is not recommended. Self-insurance may provide a reasonable spreading of the risks, but more of the benefits of independent third party review and progress toward standardization would be realized. Self-insurance would not foster the laying of valuable groundwork for a national secondary mortgage market.
- Over the longer term HFCs should explore possible relationships with successful banking institutions, whereby through loan participations and other risk-sharing arrangements, longer-term insured home loan financing can be extended to aspiring homeowners of more modest means (i.e., below median income) than is currently feasible. Such action is recommended only after MI has demonstrated a successful performance record in India, i.e., at least three to five years.

HUDCO

HUDCO – which may be viewed in some respects as a government-sponsored HFC, is in a state of major transition. HUDCO is moving from a subsidized government housing agency with a public policy mission to promote affordable housing to a more market-driven housing finance intermediary. HUDCO may, out of economic necessity, become less distinguishable from other HFCs, but its culture and long track record or serving households of lesser means may make HUDCO especially well-suited to experiment with using mortgage insurance together with other tools for directly reducing the cost of delivering housing to lower-income persons. Such experimental financing might include:

- Partnering with capable NGOs in reaching and assisting lower-income families
- Extending insured mortgage financing to housing cooperatives, which, in turn, would qualify and serve lower income families

- Assisting NGOs and apex housing cooperatives in establishing with possible third-party down support, self-insurance funds to provide a cushion against default losses and permit somewhat larger repayment terms.

* * * * * * * * *

Mortgage default insurance deserves serious consideration for early implementation in India to increase housing affordability and flow of mortgage capital. Obstacles identified in this report may deter a mortgage insurer from operating efficiently in the near term and raise its cost considerably. Over time, foreclosure reforms and other transaction cost reductions can permit mortgage insurance to fulfill its intended purposes for more effectively and at a much lower cost.

Mortgage Insurance for India

Appendixes

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Appendix A

Mortgage Insurance in the United States

Mortgage default insurance in the U.S. today rests upon the experience of a hundred years of successes, crises, and failures. While the current marketplace and that of the most recent 30 years benefits from the strong presence of both government- and privately-sponsored providers, in earlier decades, first private and then government insurers enjoyed a monopoly in the MI market.

The earliest mortgage insurance. A private MI industry consisting of some 18 carriers – most direct lenders and title insurers – flourished during the decades just prior to the Great Depression of the 1930s. These early enterprises helped draw mortgage capital into a nascent market, including via a secondary market for both institutional and retail investors--one that even included a primitive form of securitization.

The Depression imposed the ultimate test – an economic catastrophe – on these catastrophic risk insurers, and all had failed the test by 1933. A *post mortem* inquiry into the causes of this industrywide failure offered insights that remain useful to this day: (1) reserves were woefully inadequate and illiquid; (2) regulation, supervision, and audits were ineffective to nonexistent; (3) property appraisers and appraisals were lending-driven, rather than lending being appraisal-driven; (4) loans on vacant lots were insured. A prevailing national optimism about property values blinded mortgage lenders and mortgage insurers as it did most other investors.

Government mortgage insurance – the FHA. Following the collapse of private insurance, legislation in 1934 authorized a federally sponsored mortgage default insurance program under the newly formed Federal Housing Administration (FHA). FHA's goals were to revive a moribund homebuilding industry, thereby creating construction jobs and expanding homeownership. Government insurance was meant to restore lender confidence and to ease loan terms, i.e., reduce down payment (margin money) requirements and reduce monthly payments by increasing loan terms. From the beginning, FHA imposed explicit Minimum Property Standards for construction, and insured loan limits and interest rate ceilings to focus program benefits on buyers of modest means. However, the FHA was explicitly conceived as an "actuarially sound" insurance program – not a subsidy program –and there were no borrower income limits. FHA coverage included 100 percent of principal and interest, plus about two-thirds of foreclosure-related costs; premiums were paid annually at a rate of 0.5 percent of the insured loan balance. This uniform nationwide premium rate effectively cross-subsidized the very different risks inherent in higher vs. lower loan-to-value ratios (LTVs).

Over the ensuing years, FHA's central mission of expanding homeownership and homebuilding led to a steady, gradual relaxing of key program criteria. Maximum loan-to-value ratios were incrementally increased from the original 80 percent to the current 97 percent, while maximum loan amounts and loan terms were increased. Insurance was also offered for loans on larger

multifamily rental properties. FHA's current single-family loan limit is $155,250 (about Rs. 53 lakhs).

In the 1960s, FHA began experimenting with non-actuarially-sound "special risk" programs, which combined various homeowner and rental property subsidies with mortgage insurance. Many of these combined insurance-and-direct-subsidy programs suffered unexpectedly heavy losses and have since been scaled back or discontinued in favor of programs that separate these two functions.

In recent years, the FHA has become less bureaucratic and more market-driven. For example: (1) administered interest rate ceilings have been dropped; (2) indexed rate and other instrument variations are now permitted in addition to strictly fixed rate loans; (3) more underwriting authority and responsibility is delegated to lenders; and (4) premiums now vary somewhat by LTV ratio.

Although the FHA's ultimate claims-paying capacity is guarantied by the U.S. Treasury, the program is mandated to build and retain actuarially sound reserves from premiums collected, including the capacity to withstand depression-level conditions. In the early 1990s, FHA's solvency was threatened by a combination of severe economic recession, lax underwriting, lack of borrower equity, poor administration, and fraud. The FHA's actuarial soundness is examined annually by outside auditors, who concluded in 1990 and again in 1992 that life-of-loan claim rates on all FHA loans insured would exceed 11 percent for each origination year throughout the 1980s.

FHA's heavy losses arose not only from double-digit claims incidence rates, but also from high loss severity rates. Loss amounts per claim have averaged 35 to 40 percent of the total claim (total claim = sum of principal, delinquent interest, and foreclosure and property disposition costs). Measured as a percent of original loan amount, the average loss per FHA claim would approach 50 percent. Put in a time frame context, completion of an FHA foreclosure has taken an average of about 14 months from original borrower delinquency, while ultimate property disposition has taken an average of about eight months from completion of foreclosure. FHA losses have been exacerbated by the relative ease with which lenders have been able to assign delinquent loans to the FHA for full reimbursement and without completing foreclosure.

To avoid insolvency and a Treasury bailout, program parameters were tightened and premium rates were increased substantially pursuant to a long-term plan to rebuild reserves to two percent of total exposure. More recently, improved economic conditions and program performance has permitted up-front premium rates to be reduced from 3.8 to 2.25 percent. FHA's current premium charge is a fixed 2.25 ~~percent at origination~~ (~~which may be financed~~ as part of the loan amount) plus a 0.5 percent annual renewal premium. This fixed renewal rate is paid for a longer number of years on the highest LTV loans and for a lesser number of years on lower LTV loans. These program reforms and adjusted premium rates are projected to achieve long-term solvency with life-of-loan claim rates about eight to nine per hundred.

Other government insurance. In addition to the FHA, three other forms of government-sponsored MI are worthy of note: the VA guaranty program for veterans, the Ginnie Mae program for mortgage-backed government securities, and state-sponsored mortgage insurance.

The VA Guaranty Program

The U.S. Veterans Administration has, since the end of World War II, sponsored a mortgage guaranty program for qualified veterans seeking to purchase a home but lacking the required cash down payment. Strictly speaking, the VA administers a guaranty, not an insurance, program, with no requirement for actuarial soundness. Until recent years, there was no premium or guaranty fee, although the VA now does impose a one-time guaranty fee, which varies according to loan-to-value ratio. The maximum VA LTV ratio is 100 percent. VA coverage against default losses is capped at an absolute dollar amount – currently $50,750 (about Rs. 17 lakhs) – or 50 percent of the loan amount, whichever is less. While not directly subject to loans limits, VA loans eligible for government securitization may not exceed $203,000 (Rs. 69 lakhs). The VA program has no income limits. Since 1944, the VA has assisted about 15 million veterans in buying a home.

The Ginnie Mae Program

Since 1968, the Government National Mortgage Association (Ginnie Mae) has authorized issuance of mortgage-backed securities backed by pools of government-insured loans. Ginnie Mae securities carry an unconditional U.S. Government guarantee ensuring timely payment of scheduled principal and interest, whether or not payment is received from borrowers. Issuers pay to Ginnie Mae an annual guaranty fee of six basis points, which covers the timely payment and other residual risks attendant to the underlying FHA and VA loans in Ginnie Mae pools.

State-Sponsored Mortgage Insurance

About a half dozen individual U.S. states – including most significantly California – insure home mortgages against borrower default. These programs, while structured similarly to those of private mortgage insurers, generally focus by means of income and/or loan limits on moderate income first-time homebuyers. The experience of most state-run programs is relatively brief, though they appear to have been successful to date. Some have received investment grade ratings based, in part, on their implicit state backing. State MI programs raise issues of geographic risk concentration.

Private mortgage insurance. The first private mortgage insurer – Mortgage Guaranty Insurance Corporation (MGI) – began in the late 1950s. MGIC's early success was an outgrowth of a failed effort by the savings and loans' trade association to have the U.S. Congress create a Home Mortgage Guaranty Corporation under the aegis of the apex housing federal housing institution, the Federal Home Loan Bank System (see Appendix I).

Over three decades, the private MI industry grew to over a dozen members. Subsequent consolidation (and one failure) led to the current eight-member industry. All private MIs today operate nationwide and are rated 'AA' or 'AAA' by S&P and Moody's. Private and government

mortgage insurers compete to serve similar markets, and in recent years total insured loan volume has been about evenly divided between government and private providers. Private MIs have insured nearly 15 million home loans and paid policyholders about one-half million claims.

Private insurers penetrated the government insurance market with dramatically faster turnaround service; lower risk-based premiums; more flexible credit, property and loan criteria; greater variety of insurance offerings; no restrictive ceilings on insured loan amounts; and reliance on the lender to underwrite subject only to insurer review. Private insurers experienced dramatic growth when federal legislation in the early '70s authorized the use of private MI – in addition to FHA and VA – on loans sold to Fannie Mae and Freddie Mac. Throughout their existence, however, private insurers have chafed under what they perceive as unfair FHA competition, i.e., FHA's tax-free status, unconditional government backing, and eligibility as collateral for government-backed (GNMA) securities.

After many years of nearly continuouly rising home values and low claims nationwide, the early 1980s ushered in a period of great volatility and financial stress for all mortgage insurers. This period was characterized by: overbuilding; soaring double-digit interest rates; national and successive regional recessions; an energy crisis; a self-destructing savings and loan customer base; irresponsible experimentation with high-risk mortgage instruments; tax reforms that adversely affected real estate values; widespread mortgage fraud; and excess capacity within the MI industry, leading to cutthroat competition for new business. The MIs were seriously unprepared: most suffered from weak underwriting, poor risk management information and controls, inadequate pricing, sales-dominated organizations, inappropriate management incentives, and imattentive owners.

In paying over $5 billion (Rs. 17,000 crores) in claims during this period, private mortgage insurers provided the intended cushion for mortgage investors. In most cases, MI reserves proved adequate, but MI owners seeking to remain in the business were obliged to infuse substantial fresh capital in order to sustain new writing capacity. MI management responded by: tightening underwriting and financial and risk management controls; raising premium rates; improving market intelligence and data gathering; altering policy terms; discontinuing certain insurance lines (e.g., rental properties); redirecting incentive plans; and paying closer attention to the quality of loan servicing. The private MI industry returned to profitability in 1990. Since 1990, loss ratios have hovered between 50 and 60 percent of earned premium, but operating profits have soared mainly driven by new insurance written, which grew from $41 billion (Rs. 139,400 crores) in 1990 to over $130 billion (Rs. 442,000 crores) in both 1993 and 1994. During the 1980s the number of active firms dropped by nearly half.

Mortgage lenders in the U.S. are much more fragmented than in other nations where mortgage insurance is found. Consequently, U.S. mortgage insurers serve hundreds of different policyholders – mainly mortgage bankers, who sell all loans made; deposit institutions, including both savings and loan associations; and commercial banks, which both sell and hold loans. Typcially, loans are insured if the loan-to-value ratio exceeds 80 percent.

Private mortgage insurance, unlike FHA, covers only a percentage of the mortgage loan – typically the first 20 to 30 percent. (During the 1980s most U.S. MIs offered 100 percent

coverage on individual loans and on loans in mortgage pools subject to an aggregate loss limit. These lines suffered excessive losses and, after various product modification efforts, have been largely discontinued.)

Since most insured loans are now sold in the secondary market – mainly to Fannie Mae and Freddie Mac – coverage requirements are tailored to meet the requirements of these two dominant investors. A claim cannot be submitted until foreclosure is complete and the lender has repossessed the property. The total claim equals unpaid principal and interest, foreclosure costs, and property taxes and maintenance. Upon receiving a claim, the private insurer has the option of either (1) paying the entire claim amount and taking title to the foreclosed property in order to resell it and reduce the loss, or (2) paying the percent of coverage designated in the policy and leaving the property with the lender to dispose of. These two formal claim options are often avoided when the insurer approves an early resale of the property for an amount that reduces the insurer's exposure and eliminates any loss to the lender. (For master policy information providing full details of U.S. MI coverage, see Appendix J.)

Mortgage insurance risk – and therefore its premium rates – varies in the long run mainly according to loan-to-value ratio. In the U.S., the current premium rate structure is set for 90 and 95 percent LTV loans to experience ultimate claims incidence rates of roughly four to eight per hundred. While some MIs have experimented with regional pricing, the prevailing practice, as with the FHA, is to offer nationwide pricing. Notwithstanding, there are literally hundreds of different premium plan variations based on LTV ratio, loan instrument type, coverage term, premium payment plan, loan term, and partial premium refundability on cancellation. Premiums can be paid monthly (as most now are), annually renewed, or fully prepaid. Most prepaid premiums may be financed up-front as part of the insured loan amount. Typical prepaid premium rate options for 15- and 30-year term loans are shown in Exhibit A-1.

Exhibit A-1

United Guaranty Residential Insurance Company

Full-Term FinanceAbles®/Single Premiums

Full-Term FinanceAbles — 30-Year Loans

LTV	Coverage	Fixed-Payment: Reduces Exposure To	Fixed-Payment: No-Refund	Fixed-Payment: Refund	1% ARMs and Buydowns: Reduces Exposure To	1% ARMs and Buydowns: No-Refund	1% ARMs and Buydowns: Refund	2% ARMs: Reduces Exposure To	2% ARMs: No-Refund	2% ARMs: Refund
95%-90.01%	30%	67%	**4.10%**	4.90%	67%	**4.80%**	5.25%	67%	**4.85%**	5.60%
	27	70	**3.80**	4.60	70	**4.15**	5.00	70	**4.45**	5.35
	25	72	**3.60**	4.40	72	**3.90**	4.80	72	**4.20**	5.20
	22	75	**3.25**	4.30	75	**3.55**	4.70	75	**3.85**	5.05
90%-85.01%	30	66	**2.85**	3.35	66	**3.25**	3.75	66	**3.60**	4.15
	25	70	**2.50**	3.10	70	**2.85**	3.50	71	**3.15**	3.90
	22	73	**2.35**	3.00	73	**2.65**	3.40	73	**2.90**	3.80
	20	75	**2.20**	2.95	75	**2.50**	3.35	75	**2.75**	3.75
	17	77	**2.00**	2.85	78	**2.25**	3.25	78	**2.50**	3.65
	12	82	**1.70**	2.80	82	**1.90**	3.00	82	**2.05**	3.20
85% & Below	25	66	**2.15**	2.45	66	**2.35**	2.80	66	**2.50**	3.15
	20	70	**1.95**	2.35	70	**2.10**	2.70	71	**2.20**	3.05
	17	73	**1.75**	2.30	73	**1.90**	2.50	73	**2.00**	2.65
	15	74	**1.65**	2.18	74	**1.78**	2.36	75	**1.86**	2.51
	12	77	**1.50**	2.00	77	**1.60**	2.15	77	**1.65**	2.30
	6	82	**1.35**	1.55	82	**1.45**	1.75	82	**1.50**	1.90

Full-Term FinanceAbles — 15-Year Loans

LTV	Coverage	Fixed-Payment: Reduces Exposure To	Fixed-Payment: Refund	1% ARMs and Buydowns: Reduces Exposure To	1% ARMs and Buydowns: Refund	2% ARMs: Reduces Exposure To	2% ARMs: Refund
95%-90.01%	30%	67%	2.25%	67%	2.40%	67%	2.55%
	27	70	2.10	70	2.25	70	2.40
	25	72	1.90	72	2.10	72	2.30
	22	75	1.80	75	1.95	75	2.05
90%-85.01%	30	65	1.60	65	1.80	65	1.95
	25	69	1.35	69	1.50	69	1.65
	22	72	1.30	72	1.45	72	1.55
	20	73	1.20	73	1.35	73	1.45
	17	76	1.10	76	1.25	76	1.35
	12	80	1.00	81	1.15	81	1.30
85% & Below	25	65	1.20	65	1.35	65	1.45
	20	69	1.10	69	1.25	69	1.35
	17	72	1.05	72	1.20	72	1.30
	15	73	0.99	74	1.12	74	1.22
	12	76	0.90	76	1.00	76	1.10
	6	81	0.75	81	0.85	81	0.95

30-Year Loans: 21-40 years amortization. **15-Year Loans:** 0-20 years amortization

All U.S. insurance, including mortgage default insurance, is regulated not by the central government but by the individual states. Since the 1960s, states such as California, New York, Wisconsin, Illinois, and Texas have promulgated regulations that recognize the uniqueness of mortgage default insurance. Generally consistent with these state regulations, the National Association of Insurance Commissioners has developed a special Model Act for governing MIs. Notable features of both state regulations and the Model Act are: (1) the requirement that U.S. insurers be chartered as "monoline" entities whose reserves must be solely attributable to mortgage default risks; (2) the refinement that minimum policyholders' reserves be equal to four percent of total risk exposure, including a unique catastrophic "contingency reserve" equal to 50 percent of all earned premium, which must be segregated and retained for ten years; and (3) a prohibition against payment of commissions or other financial inducements to lender-policyholders; and (4) a prohibition against writing insurance for any lenders who are MI owners or affiliates. (A full text of the Model Act appears in Appendix K.)

In addition to state regulation, *de facto* oversight and supervision of U.S. mortgage insurers is exercised by Fannie Mae and Freddie Mac, both of whom require MIs to meet certain standards of performance as a condition of approval for coverage of loans purchased by these two agencies. Further *de facto* oversight is provided by Moody's and Standard & Poors as part of the periodic rating process. In fact, the most comprehensive and focused third-party review and reporting on each MI's solidity comes from the rating agencies, who apply sophisticated financial and economic models to judge an insurer's future claims-paying capacity under severe stress. By contrast, most state insurance examiners have little understanding of mortgage finance and the type of long-term economic risks assumed by MIs.

Apart from the private mortgage insurance described above, the timely payment guarantees provided to their securityholders by Fannie Mae and Freddie Mac may also be considered a form of private mortgage insurance. A minority of the Board members of these two agencies is still appointed by the U.S. President, and the agencies are still subject to limited government control by the U.S. Department of Housing and Urban Development (HUD) and enjoy a degree of favored status, including limited U.S. Treasury backup and exemption from securities registration. However, Fannie Mae and Freddie Mac are essentially privatized as New York Stock Exchange-listed firms. The home mortgages purchased by these corporations include both insured and uninsured loans. Both agencies charge a negotiated guaranty fee for their Ginnie Mae-type timely payment guaranty on their mortgage-backed securities.

In summary, mortgage default insurance in the U.S. has, since the Great Depression sixty years ago, played a central role in increasing the nation's homeownership rate from about 40 percent to the current 65 percent level.

Appendix B

Mortgage Insurance in Canada

Canadian mortgage insurance has been characterized for several decades by competition – sometimes healthy and sometimes detrimental – between a government-sponsored insurer and one or several private insurers. As in the U.S and other countries with extended mortgage insurance experience, the performance of Canadian MIs has been heavily impacted by national and regional economic cycles and recognizable risk patterns relating to several key loan characteristics.

Market environment. Home loan originations are dominated across Canada by about a half dozen charter banks and trust companies operating nationwide. The typical loan instrument in Canada is a 25-year amortizing loa,n with provisions for interest adjustments at rollover intervals typically ranging from six months to five years. The foreclosure process operates with reasonable efficiency throughout Canada's 12 provinces and territories, typically requiring nine to 18 months to complete. All loans in Canada over 75 percent LTV carry either government or private default insurance.

Government mortgage insurance. The Canada Mortgage and Housing Corporation (CMHC) has been providing government (NHA) mortgage default insurance to private lenders for new housing since 1954 and for existing housing since 1966. The program provides 100 percent coverage of principal plus up to 18 months of accrued interest and allowable costs. The procedure for acquiring insurance entails: (1) the lender securing approval to participate in the NHA program; (2) submission of individual loan applications for CHMC insurance approval; (3) advancement of the loan proceeds and remittance of the insurance premium to CMHC. Insurance is offered for home construction, purchase, and refinance; for owner- and renter-occupied units; and on first and second mortgages, including chattel mortgages on manufactured homes.

Since 1992 the maximum insurable loan-to-value ratio has been 95 percent, and currently one half of all NHA insurance is issued for loans exceeding 90 percent LTV. Earlier experimentation with 95 percent LTV lending in the 1970s had resulted in very high claims rates during subsequent economic recession. As a result, for a number of years prior to 1992, both CMHC and private insurers had limited their insurable LTVs to a maximum of 90 percent.

In the face of interest rate volatility, CMHC has also experimented with a unique Mortgage Rate Protection Program to protect NHA-insured borrowers against payment shock. Although the program continues to be offered, it has been little used because of its high cost with strictly capped benefits and because rates have been moderating. The low usage may be fortunate, as interest rate insurance is considered to embody more serious catastrophic risks than standard mortgage default insurance.

In support of its own very modest mortgage securitization program, CMHC also offers a program for timely payment of principal and interest on mortgage pools, similar in concept to the Ginnie Mae program in the U.S. (In contrast to the U.S., a private secondary market has not evolved in Canada.)

The standard premium rate structure for NHA insurance of individual home loans entails a single prepaid premium, which may be paid at closing by the borrower or effectively financed over the loan life by adding it to the original loan amount. Premium rates vary by initial loan-to-value ratio-ranging, for example, from 1.75 percent of the original loan amount for an 80 percent LTV loan to 2.50 for a 95 percent LTV loan. A 0.50 percent premium surcharge is applied for loans requiring more than one advance, i.e., construction financing.

CMHC's general policy regarding premium rates is effectively to cross-subsidize between its highest risk (i.e., 95 percent LTV) insured loans and its lower risk, lower LTV loans. Therefore, even though CMHC's earlier history (1975-85) shows that 95 percent LTV insured lending produces claims rates more than twice that of comparable experience for 90 percent LTV loans, the current premium rate for 90's and 95's is identical. The purpose of this cross-subsidization is to enhance affordability for the sizable population of potential borrowers at the margin.

In 1994, CMHC issued insurance for the financing of over 300,000 residential units, which accounted for about 40 percent of all home mortgage lending Canada-wide. After a period of favorable performance results, a market slowdown combined with a shift in business mix to the higher risk 95 percent LTV loans has resulted in rising defaults and claims and – loss reserve increases for anticipated claims are included – significant current underwriting losses. (see Exhibit B-1)

Exhibit B-1

Canada Mortgage and Housing Corporation

In millions of dollars	1994	1993
Mortgage Insurance Fund		
Issuance (thousands of units)	306.4	296.6
Claims Paid	512.9	482.4
Pre-tax Earnings (Loss)	(89.4)	(59.7)
~~Surplus (Deficit)~~	(78.0)	15.4
Insurance in Force	102.2	86.5
Mortgage-backed Securities Guarantee Fund		
Issuance	3 719.7	6 579.8
Net Earnings	6.4	5.6
Surplus	16.6	10.2
Guarantees in Force	17 500	16 300

Private mortgage insurance. Private mortgage insurance in Canada dates to the 1960s. For a period during the 1970s and early 1980s,private MIs included two or three competitors. The pressures of government competition, limited market size, and diseconomies of scale, however, eventually led to consolidation into a single private insurer – Mortgage Insurance Company of Canada (MICC). Competing one-on-one with the government-sponsored CMHC, the privately-held MICC typically captured 25 to 30 percent of Canada's insured loan market.

Of necessity, MICC maintained program coverage and premium rates competitive with NHA insurance. However, competitive moves to increase coverage to 100 percent and raise maximum LTVs to 95 percent without substantial boosts in premium rates were inmplemented reluctantly by MICC, which sensed that added risks assumed were excessive and underpriced. Free of obligations to generate returns to shareholders, CMHC was perhaps more inclined than MICC to implement its public policy mission by reaching for more marginal borrowers and marginal risks, as has been the case with the FHA in the United States.

These concerns over risk were well founded. Both government and private MIs suffered heavy claims during the energy crisis and recession of the mid-1980s. However, MICC suffered far more severely than the government-sponsored program. The reasons for this are instructive. One province, Alberta, was the focal point of massive defaults caused by falling oil prices. By coincidence, Alberta's provincial laws relieved defaulting borrowers of any personal liability on their mortgage and note following foreclosure. Furthermore, government-insured loans were exempt from this provision. Consequently, MICC encountered severe adverse selection of risk in Alberta. During the mid-1980s nearly three fourths of MICC's claims came from this one province, which had been producing only about one quarter of its total insurance writings.

Weakened by $250 million (Canadian) of claims losses and nearly $175 million of net earnings losses in 1983 and 1984, MICC's insurance operations in 1985 regained their profitability. MICC continued to operate until 1993, at which time, unable to attract sufficient new capital, it stopped writing new business. During this latter period, CMHC provided reinsurance for MICC such that MICC could retain an investment grade rating.

In 1996, after a two-year interlude without private competition, government-sponsored insurance in Canada now faces a new private competitor. GE Capital Mortgage Corporation, parent company to GE Capital Mortgage Insurance Corporation, a leading U.S. mortgage insurer, has launched GE Capital Mortgage Insurance Canada. With insurance program parameters and a premium rate structure similar to that currently offered by CMHC, GE plans to compete on responsive service (including two-hour approvals) and technology.

Appendix C

Mortgage Insurance in the United Kingdom

The volatile experience of mortgage insurers in the United Kingdom over the past decade offers valuable lessons for anyone evaluating how to manage mortgage default through the use of mortgage default insurance.

Background. Until the early 1980s, U.K mortgage insurers experienced a period of relative stability, low volumes, and reasonable profits. Mortgage insurance was, and still is, used by lenders in cases where certain borrowers needed higher loan-to-value ratios to afford a home purchase or where borrowers' credit was marginal. Most mortgage lending was done by building societies, which in many ways resemble HFCs in India and savings and loan associations in the U.S.

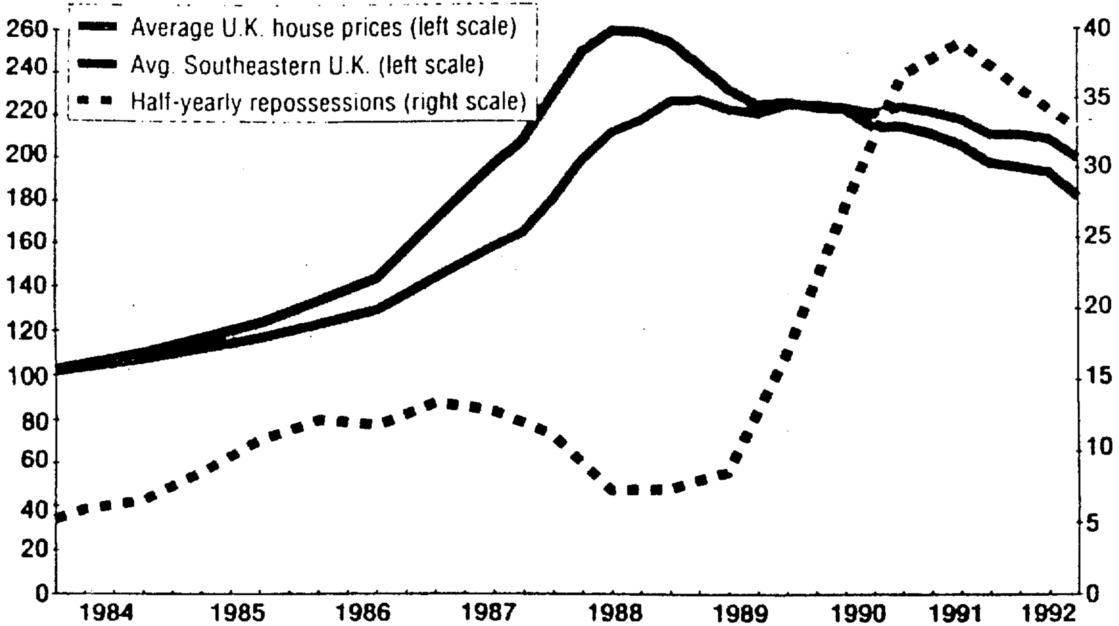
After 1980, competition for mortgage loans increased as other lenders, including banks and foreign investors working through brokers, entered the U. K. market. Underwriting standards were relaxed considerably. Home price-to-income multiples increased from a traditional 2.5-3x, while average loan-to-value ratios for first-time buyers and average installment-to-income ratios both increased by over ten percentage points. Greater availability of financing, together with falling interest rates, a strong economy, and market optimism all contributed to rapidly rising home prices. From 1982 to 1988, average new home prices in the U.K. rose 114 percent while the general price index increased only 32 percent.

Beginning in 1988, with the money supply tightening, mortgage rates rose from 9.5 to 15.5 percent in a little over two years. With the typical home mortgage payment indexed to interest rates, many existing mortgage payments rose to unaffordable levels, while the population of borrowers able to qualify for new loans shrank dramatically. Conditions continued to deteriorate after 1990, with unemployment rising from 1.6 million to 3 million in less than three years.

While property sales nationwide fell about 40 percent between 1988 and 1991, home values in southeastern England, including London, fell over 30 percent. Rising borrower defaults and falling property values inevitably resuled in massive foreclosures. Foreclosures numbered nearly 44,000 in 1990, over twelve times the corresponding count a decade earlier. One year later, in 1991 over 75,000 foreclosures were recorded (see Exhibits C-1 and C-2).

Exhibit C-1

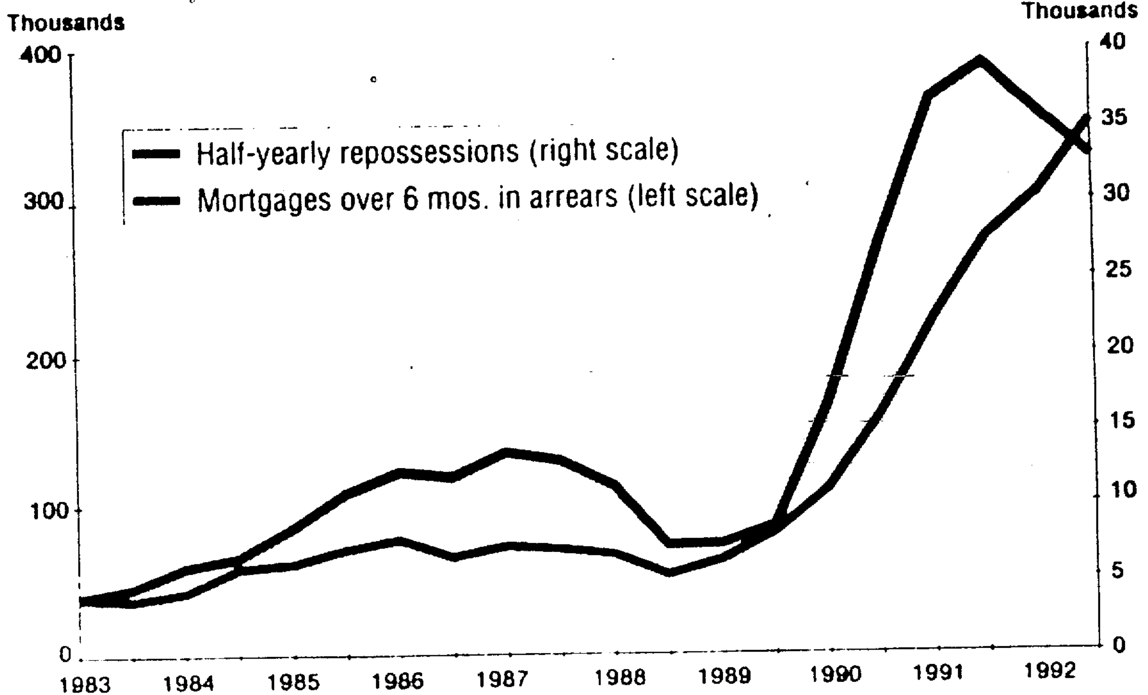
HOUSE PRICES VERSUS REPOSSESSIONS



Sources: Halifax Building Society and Council of Mortgage Lenders.
House price indices are derived from the society's mortgage approvals and base weighted to take into accout changes in the mix of houses between quarters.

Exhibit C-2

REPOSSESSIONS VERSUS ARREARS



Source: Council of Mortgage Lenders

Since default insurance was placed on most loans exceeding 75 percent LTV, mortgage insurers faced a recipe for disaster. From 1990 to 1992 alone, five leading U.K. insurers lost 2.4 billion pounds (approx. Rs. 13,200 crores), or nearly one half of their net assets at the beginning of 1990. (Unlike in the U.S., segregated financial statements are not available for mortgage insurers in the U.K.) A November 1991 report by the Paribas Capital Markets Group called these mortgage default losses "the gravest crises facing the UK financial industry since the sovereign debt crisis."

The mortgage insurers reeled, but with one notable exception, survived. Since 1992 the survivors have reformed their insurance and risk management practices. Actions taken have included: (1) significant premium increases; (2) redesign of the basic insurance policy to increase the insured lender's share of risk; (3) redefining/reconfiguring risk coverage; (4) generally tightening underwriting criteria; and (5) strengthening policy defenses with regard to underwriting misrepresentations.

Mortgage lenders. Building societies, of which fewer than 20 dominate the industry, are home lending specialists that account for about three fourths of all home loans made in the U.K. Building societies are the mortgage insurers' major policyholders. While the foreclosure system operates much more efficiently in the U.K. than in India, the building societies are much more averse to foreclosing than are U.S. lenders. Efforts to reach non-foreclosure resolutions with defaulting borrowers are far more extensive. Most building societies avoided the heavy losses suffered by mortgage insurers and borrowers, but some societies that wrote high LTV loans without insurance did not survive.

Mortgage insurance programs. The U.K. mortgage insurance industry is dominated by about onae half dozen carriers. Most have traditionally marketed a life insurance (indemnity) policy and other homeowner coverages along with mortgage default insurance. Before the period of heavy losses, the latter appears to have been underpriced. Despite competitive variations, common program features have predominated, both before and following recent changes.

Premium rates, which vary by loan-to-value ratio, are calculated by applying the prepaid rate to the portion of the loan that exceeds a standard, uninsured loan as defined by the lender. Prior to late 1991, when rates were raised 10 to 50 percent, one-time premium rates ranged from 4.5 to 6.5 percent of the amount insured, depending on LTV ratio. Premium rates are paid by the lender, but the cost is passed to the borrower via a corresponding increase in the loan amount.

Prior to recent changes, coverage was calculated to include all losses that a lender would suffer as a result of having made a loan exceeding that lender's standard maximum uninsured LTV ratio. In practice, the lender shared little risk under this type of policy. Foreclosure and resale costs were covered in full, and a substantial buildup of accrued interest in arrears combined with loss in property value needed to occur before the lender began to share in any losses. With hindsight, it is clear that such an arrangement caused moral hazard in underwriting during boom times and in collections during the subsequent period of economic distress.

Recent changes in coverage terms include: (1) a new blanket "coinsurance" feature that limits the insurer's *share* of total losses to 80 percent of the lender's total loss; and (2) an absolute loss limit equal to the amount by which the high LTV loan exceeds the lender's 'standard' uninsured loan limit.

Appendix D

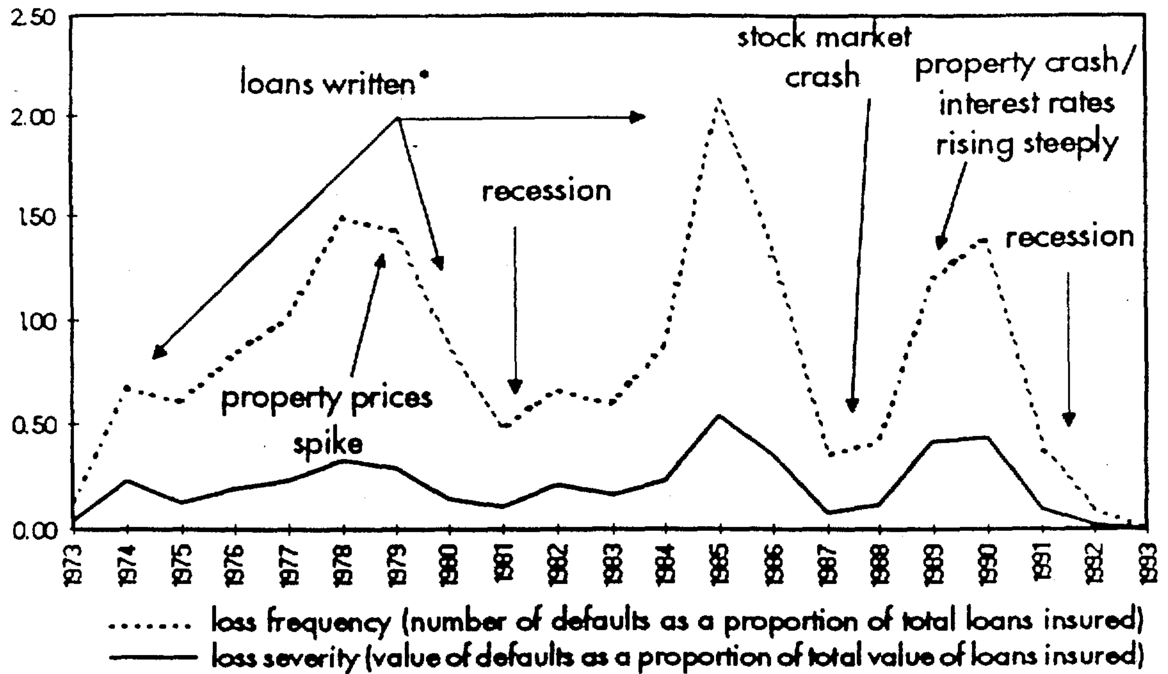
Mortgage Insurance in Australia and New Zealand

Mortgage insurers in Australia and New Zealand have experienced claims and loss patterns more favorable than their U.K. and U.S. counterparts over the past decade. However, they have witnessed the same sharp cyclicality of claims and losses, relative to general economic conditions, e.g., unemployment, interest rates, and home prices (see Exhibit D-1). Despite the volatility, Australian MIs' claims incidence has averaged only 0.65 percent of total loans insured, while loss severity has averaged only 0.17 percent of total loan amount insured – both measures just a fraction of comparable experience in the U.S. and U.K.

Notwithstanding this enviable performance, great concern has arisen recently that too many lenders are striving to maintain or grow loan volume while loan demand is shrinking. These circumstances can quickly result in lax underwriting, poor loan quality, and soaring claims, as occurred in the U.S. and the U.K.

Both claims incidence and loss severity have varied considerably by loan-to-value ratio. Claims incidence for 85 to 90 percent LTV loans has been double that of 75 to 80 percent LTV loans, while LTVs exceeding 90 percent show claims incidence patterns over three times that on 75-80 percent loans. Loss severities on loans exceeding 90 percent LTV have been more than double those on loans having 75 to 80 percent LTV ratios (see Exhibit D-2).

Exhibit D-1



**—Loans written in year immediately preceeding sharp interest rate rises (i.e. borrowers experiencing payment shock). Source—Mortgage insurers.*

Exhibit D-2

Residential mortgage insurance claims by loan-to-value ratio (LVR) category

LVR category	Claims frequency (%)	Loss severity (%)
90%+	2.50	0.42
85%-90%	1.50	0.35
80%-85%	1.00	0.25
75%-80%	0.75	0.20
0%-75%	0.45	0.18

Note: Figures reflect proportion of claims against number of loans insured and loss severity against value of loans insured in each LVR category.

Source: Standard & Poor's

Residential mortgage lending in Australia and New Zealand is dominated by a small group of nationwide banks. The typical mortgage instrument in both countries is a 25-year indexed-rate loan. In New Zealand, the government-owned Housing Corporation of New Zealand (HCNZ) has also been a leading provider of home loans, which have been targeted to borrowers of more modest means. HCNZ loans were held in government portfoli until recently, when the government undertook to securitize and sell to private investors – with the benefit of private mortgage pool insurance – its sizeable mortgage portfolio.

The Australia/New Zealand mortgage insurance industry, which began in the mid-1960s, consists primarily of three private carriers and, in Australia, one government-sponsored provider, Housing Loans Insurance Corporation (HLIC). Australia's government-sponsored insurer has traditionally written about half of all insured business, but announced plans to privatize HLIC have reduced its market dominance. Several state governments in Australia issue guarantees for mortgage-backed bonds secured by pools of loans made to moderate-income families. These loans, too, are generally insured by the private insurers. The claims-paying capacity of the leading MIs is highly rated by Standard & Poor's and Moody's.

The predominant Australia/New Zealand mortgage insurance product, which originally imitated the standard "top 20 percent" coverage of U.S. insurers, was expanded to 100 percent coverage some years ago. However, a variety of partial coverage options are still offered for reduced premiums. On the other hand, expanded coverage in the form of cash flow guarantees is offered for an additional premium. Home loans over 75 to 80 percent LTV are typically insured up to a maximum of 95 percent LTV. Typical premiums for standard 100 percent coverage calculated as a one-time percentage of the original loan amount – run from 0.40 percent for 80 percent LTV to 1.40 percent for 95 percent LTV. The one-time premium may in effect be financed by adding it to the initial insured loan amount.

A typical offering provides for a 20 percent reduction in premium when the selected coverage is top 20 percent, rather than 100 percent. A policy endorsement covering cash flow, in addition to ultimate losses following foreclosure, calls for an incremental 25 percent premium payment. Foreclosures in both Australia and New Zealand are typically completed in well under a year, after which defaulting borrowers remain personally liable for any remaining unpaid debt.

While standard mortgage insurance products and rates are published in Australia and New Zealand, considerable business is conducted pursuant to negotiated underwriting arrangements between insurers and individual lenders.

Despite their small number, Australian MIs have formed a Mortgage Insurers Association to address common issues of industry concern.

Appendix E

Mortgage Insurance in Sweden

BKN, the Swedish National Housing Credit Guaranty Board, is a national government agency under the Ministry of Industry and Commerce. BKN, which began operations in 1992, provides government credit guarantees for loans raised on the credit market to finance housing construction and rehabilitation projects that are entitled to interest subsidies. BKN also monitors and disseminates information about credit and capital market developments affecting housing.

BKN is organized in two units: (1) administration, guarantees and defaults; (2) the Director-General's office. BKN operates with a small administrative staff and low overhead. At the end of September 1995, BKN had 13 full-time positions. To minimize administrative costs in the credit guarantee system, BKN has built up what is essentially a paper-free system for the registration and safe-keeping of guarantees, thereby reducing processing time and enabling lenders to coordinate loan advances and the registration of the credit guarantee. Administrative costs amounted to 11.8 million kronor (approx. Rs. 5.9 crores), which equals about 0.05 percent of the total guarantee amount outstanding.

The guaranty program. Credit institutions purchase guarantees from BKN and pay an annual fee. BKN has reached agreement with the mortgage institutions on how applications can be handled and credit guarantees issued using databases. Under this agreement, the institutions normally accept responsibility for assessing whether the relevant requirements are fulfilled in any particular case.

The lending institution has a number of responsibilities. It must make a correct credit appraisal of the borrower, and it must administer the loan in a satisfactory manner, observing good lending practices. In the event that a mortgage institution requests compensation under a guarantee, BKN examines whether the institution has fulfilled its obligations and, consequently, whether the guarantee is valid. Guarantees can, however, be examined in advance by BKN at the request of the credit institution.

The mortgage institution can register credit guarantees in BKN's database at the National Board for Real Estate Date (CFD) without prior consideration of the case by BKN. This database is linked to the CFD database, so that the lender can at the same time access necessary information from the national property register database. Registered credit guarantees begin to operate at the point in time stipulated by the institution when the registration is made.

Credit guarantees can be provided for loans advanced by private financial institutions. As of mid-1995 BKN had guarantee agreements with 24 credit institutions.

Although the government is ultimately responsible for BKN's liabilities,the guaranty program is designed to be operated on an actuarially sound basis. That is, in the long term, the credit guarantee system, including BKN's administration, must be financed by income from guaranty fees. At present the annual guarantee fee is 0.5 percent of the guaranteed amount.

From the start of operations in January 1992 until June 30, 1995, BKN provided guarantees for the construction of 69,000 new dwellings and the rehabilitation of 83,000 existing dwellings, with an aggregate guarantee amount of 23.6 billion kronor (approx. Rs. 11,800 crore). The total guarantee value for the projects was 89.5 billion kronor (approx. Rs. 44,800 crore). New construction accounted for 80 percent of the amount guaranteed, and rehabilitation for 20 percent. Cooperative housing accounted for 55 percent of total guaranteed financing, rental housing 30 percent, and owner-occupied housing 15 percent.

Two distinct credit guarantey schemes for housing construction and rehabilitation finance are defined by 1992 and the 1993 regulations respectively. The guaranty is provided against collateral provided by the mortgage on the property. The guaranty, which must be applied for within one year of completion of construction, may be provided for up to 25 years from the completion of construction or rehabilitation work. The guarantee is not effective until completion of construction.

BKN's credit guaranty is a partial guaranty, covering a designated percentage of the "approved guarantee value," which is generally the same amount used by the government in calculating allowable interest subsidies. In principle, this amount corresponds to the housing production cost, which often differs from the property's actual market value.

Under the original 1992 credit guaranty system, the government retained responsibility for credit risks of the same size and character as in the previous system of government-regulated housing loans. These credit guarantees cover "top-up" financing for projects started before the end of 1992. The guaranty is available for 25 to 30 percent of the guaranty value, depending on the category of owner.

Under the revised 1993 guarantee system, interest subsidies and credit guarantees are available only for up to 120 square meters of living space per dwelling. The credit guarantee has been increased from 30 to 40 percent of the guaranty value for projects begun in 1993-95. The credit guarantees may be increased by one percent of the original guaranty value for each year of the guaranty period. This increase, which cannot exceed 10 percent of the original guarantee value, provides some scope for deferred interest lending.

~~The guaranty must be secured by a mortgage placed directly above the loan~~ provided by the lender solely on the basis of mortgage security in the property and below 100 percent of an approved mortgage value. The maximum guaranty value is 965,000 kronor (approximately Rs. 48 lahks) per dwelling.

Default management is mainly the responsibility of the lender. The lending institution is responsible for administering a loan guaranteed by BKN in the same way as a loan without such a guaranty. An institution that neglects this responsibility is taking the risk that its guarantee will

be invalid. Attentive collections are especially important because, unlike in some countries, automatic debiting of a borrower's mortgage payment from his bank account is not prevalent in Sweden.

BKN's guaranty compensates the lender for losses on a guaranteed loan due to the borrower's inability to repay the loan. In general, the property securing the loan must be sold if the lender wants to be compensated through the BKN guaranty. Under a recent program change, BKN may participate in "composition agreements," in which compensation is paid under the guaranty without the property being sold. This alternative is approved when the expected loss resulting from the composition recommendations will be significantly lower than if the property were sold.

Compensation from a BKN guaranty covers loss of loan principal, interest in arrears, and legal and other costs. The maximum compensation is 115 percent of the loan value covered by the guaranty plus interest at a standard rate during the compulsory procedure. This supplement corresponds to the provision for arrears and other costs made in the relevant land legislation.

When BKN compensates losses under its credit guaranty, it takes over the lending institution's right to demand repayment of these losses from the borrower. If the borrower is regarded as unable to repay the debt in the foreseeable future, BKN can forgive this debt wholly or in part. There is no appeal against the decisions of BKN.

Losses. From the start of operations on January 1, 1992 until June 30, 1995, the Board has approved guaranty compensation payments totalling 388 million kronor (approx. Rs. 194 crores). So far, most of BKN's guaranty losses have related to rental housing. A corresponding trend for cooperative housing is expected. Guaranty losses for owner-occupied housing are expected to be much more limited. Helping to limit defaults and losses are a national system of generous and extended unemployment benefits and the power of authorities to withhold a portion of a borrower's salary to cover unpaid mortgage debt. Foreclosures normally take a year or less.

BKN's guaranty losses relate primarily to housing completed in 1992-93 with guarantees issuedunder 1992 regulations, which are based, in principle, on actual production costs. This housing was built under completely different conditions from those that apply now. The problems for this housing are caused by high production costs in combination with a shift to an economy with low inflation, high real interest rates, reduced government subsidies, and lower house prices than what prevailed in the early 1990s. According to a forecast that BKN supplied to the government, guaranty losses for the most exposed years of production may amount to 6,000 million kronor (approximately Rs. 3,000 crores).

Housing finance in Sweden. In 1995, there were eight major mortgage institutions specializing in lending for housing, six of which are subsidiaries of banks. Construction lending is separately provided by banks. The housing-oriented mortgage institutions provide loans up to 75 percent of market value, usually with a repayment period of about 50 years. Normally,. interest on loans advanced by the housing-oriented mortgage institutions is fixed for five years at a time, although shorter periods are also set. As of 1994, a large part of new lending has been at variable interest rates.

Sweden's housing-oriented mortgage institutions account for about 90 percent of home mortgage lending. While banks account for most of the remaining 10 percent. Twelve percent of total housing lending is in the form of government-regulated loans administered by the Swedish National Housing Finance Corporation (SBAB) – a wholly government-owned housing mortgage institution).

The loan portfolios of the housing-oriented mortgage institutions totalled some 960 billion kronor (approx. Rs. 480,000 crores) as of June 30, 1995. Gross new lending by the housing-oriented mortgage institutions in 1994 totalled some 70 billion kronor (approx. Rs. 35,000 crores).

The housing-oriented mortgage institutions raise funds primarily through bond issues or other long-term borrowing (82 percent as of June 30, 1995) and through commercial paper (12 percent) and other short term borrowing (six percent). The main participants in the bond market are the National Pension Insurance Funds, the insurance companies, and the banks. In recent years, the housing-oriented mortgage institutions have extended their activities by borrowing directly from the public in the private market by issuing bonds.

As of January 1, 1992, under the newer housing finance and subsidy schemes, private housing-oriented mortgage institutions compete on an equal footing to provide credit for new and rehabilitated housing. Government credit guarantees for the financing of housing development in the credit market are replacing the government-regulated loans, which, since 1985 are being gradually phased out.

In principle, all new housing, regardless of tenure, is financed with government interest subsidies. The National Board of Housing, Building and Planning is responsible for administering government interest subsidies. For the 1994-95 fiscal year, these general subsidies for housing development amounted to 32.7 billion kronor (approx. Rs. 16,350 crores), or some 2.2 percent of gross domestic product. Since 1992 these subsidies have been available regardless of how a project has been financed, although plans are for such subsidies to be substantially reduced or eliminated.

Note: The above information on Credit Guarantees for Housing Development in Sweden was provided by The Swedish National Housing Finance Corporation (SBAB).

Appendix F

Mortgage Insurance in the Philippines

The Philippines. The Home Development Mutual Fund (HDMF), a public institution, provides guarantees for construction and development loans made by banks to private developers and also guarantees loans made to individual homebuyers. Home Insurance Guaranty Corporation (HIGC), also a public institution, guarantees mortgages that, as a result, are accepted by the market to be as risk-free as government paper.

(Mortgage insurance in the Philippines is handled under the auspices of the Home Insurance and Guaranty Corporation (HIGC). HIGC is one of several wholly owned government corporations established under the nation's National Shelter Program to implement a housing finance system that serves low- and moderate- as well as higher income households.

HIGC offers to private institutional lenders a full guaranty of principal and interest for the following types of housing-related loans:

- retail loans to individual homeowners for home purchase, improvement or refinance (program is restricted to owner-occupant borrowers and established loan limits)
- loans to housing developers secured by sales contract receivables
- apartment construction loans
- municipal bonds backed by housing developments

The program's primary purpose is to induce private lenders to support housing production and upgrades with loans that might otherwise be considered too risky. In particular, allowable loan-to-value ratios are extended from an uninsured limit of 70 percent up to a maximum 95 percent (and in certain cases 100 percent) loan-to-value ratio. Claims resulting from borrower default are paid only when the subject property is promptly foreclosed and conveyed to the insurer, together with an assignment of all residual lender claims against the borrower and any third party guarantors.

The guaranty fund--currently capitalized by statute at 2.5 billion pesos (Rs. 340 crores)--must be maintained at a minimum 1/20 of total guaranteed risk outstanding. Premium rates are to be set at levels that will permit the guarantee program to be self-sustaining. Premiums are paid annually and range from less than one percent for bond guarantees to 1 1/4 to 2 1/4 percent for cash guarantees. Application, enrollment and annual audit fees are added to the insurance premium for developer programs, but not for retail loans to homeowners.

Nearly four dozen institutions participate in HIGC's retail guaranty program; about three dozen lenders use the developmental (apartment) guarantee program; and about one dozen developers each use the HIGC project guarantee program and insured financing backed by builders' residential sales contracts.

Finally, HIGC provides financing support for non-traditional housing providers, i.e. cooperative housing associations, including technical assistance and, as appropriate, guarantees for the loans taken by the cooperative housing associations.

Appendix G

Summary of Other International Home Loan Guaranty Programs

In addition to the six mortgage insurance programs discussed in detail above, a number of additional countries offer some form of home loan guaranty program. Such programs, which typically are sponsored by a government agency and not operated as insurance programs in an actuarial sense, are described briefly below. The summary information below has been provided mainly by the International Union of Housing Finance Institutions via its *1995 International Housing Finance Sourcebook*.

France. *Prêt aide à l'accession à la propriété*, or PAP loans, are government-provided interest-subsidized loans to moderate income households for newly constructed housing. Until about 1993, PAP guaranteed its loans to the extent of the excess over 60 percent loan-to-value ratio. An additional loan program, the *prêt accession social* (PAS), was introduced in 1993. Under this program the government provides guarantees for loans made to marginal borrowers. There was a rise in defaults after the "Neiertz law" offered relief to "overindebted" persons. Rising defaults have made mortgage lending institutions more cautious, resulting in greater use of guaranteed mortgages.

France also has a widely used home mortgage finance scheme, known as the *cautionnement* system, which resembles mortgage default insurance but, properly speaking, is not. The *cautionnement* is worthy of note from India's perspective, because it is a type of guarantee that is expressly designed to address the difficulties of the French foreclosure system under which recovery of collateral is very time-consuming, costly, and unpredictable. Under this unique alternative to a traditional mortgage loan, a *"caution"* is purchased from a third-party guarantor with respect to a personal loan used to finance the purchase of a home. In the event of borrower default, the *caution* provider has the right, at that point, to file a mortgage lien against the property and proceed with a recovery action. The *cautionnement* system permits loan originations to proceed much more efficiently, mortgage registration costs to be avoided, lower risk-based capital requirements to be applied, and the risks associated with foreclosure costs to be shifted to an entity which specializes in dealing with this problem that is peculiar to the French (and possibly the Indian) system of mortgage finance.

Honduras. *Fondo de la Vivienda*, or FOVI, is a public housing finance institution administered by the Central Bank of Honduras. FOVI's mission is to develop credit policy for housing, promote development of S&Ls, run a secondary mortgage market, and promote low-income housing finance. FOVI acts as an "apex" housing institution, providing funds and loan guarantees through intermediary institutions. There are currently 16 such intermediaries, of which seven are saving and loan associations.

Hong Kong. The Hong Kong Housing Authority (HKHA) operates a home loan guarantee program to encourage private financing of individual units sold by the HKHA to lower-middle income families. Although most owner-occupied housing is private, about 18 percent of Hong

Kong's home sales involve public housing. Purchasers of public housing units can obtain 90 and 95 percent loan-to-value ratio loans for 20-year terms at favorable fixed rates.. Properties are purchased from the Housing Authority at below-market prices. The guaranteed loans, which in 1994-95 were made by 44 participating private banks, are guaranteed by the Hong Kong HHousing authority. General underwriting criteria are established by each individual bank. Borrower payment-to-income ratios average 35 percent. Out of over 200,000 loans guaranteed over the program's 12-year history, fewer than 300 have defaulted. The Authority's loan guarantee program does not charge a premium, nor does it set aside dedicated loss reserves.

Korea. The Korea Housing Bank has managed a Housing Finance Credit Guarantee Fund since 1988. The Fund's purpose is to make mortgage financing more readily available to borrowers having limited equity by protecting lenders from losses caused by borrower default. Though government-sponsored, a small percentage of the Fund's resources comes from private lenders. About three-fourths of the Fund's guarantees are issued for individual home loans, with the remainder being issued for multifamily cooperatives.

Mexico. *Fondo de Operación y Financiamiento Bancario a la Vivienda,* or FOVI, is a government-sponsored housing program whose funds come from the Central Bank and the World Bank. Funds are made available to developers through commercial banks via public auctions. Developers who use FOVI funds must build and sell homes with prices ranging from 8 to 13 times the established minimum annual wage. Commercial banks provide the loans to borrowers and, in turn, have the loans rediscounted or guaranteed by FOVI. Most borrowers covered under the program earn three to six times the minimum wage. FOVI funding financed the construction and sale of about 43,000 homes in 1994. Moderate-income households rely on the availability of FOVI loan guarantees, while higher income buyers do not. Because home mortgages are "dual indexed," recent hyperinflation has caused rising payments, negative amortization, and high default rates. As in India, foreclosures in Mexico are time-consuming and costly.

The Netherlands. The typical mortgage loan has a term of 30 years and is available up to 70 percent loan-to-value ratio without mortgage insurance. With private insurance, loans up to 100 percent LTV are possible, subject to a maximum purchase price. The government provides backup reinsurance to the private guarantor. The percentage of loans guaranteed by the "Municipal Guarantee" scheme fell in 1993, while the number of requests for such a guarantee has remained stable at around 70,000 per year. This program was due to be privatized in 1995.

Peru. FONAVI is a public sector housing finance institution funded by contributions from all workers and their respective employers. Workers and employers each currently contribute three percent of the employee's wage. In 1993 FONAVI had over 1.1 million individual contributors. FONAVI mainly provides grants and subsidized loans for lower income households. FONAVI also provides loan guarantees and partial financing for middle income households to purchase a home.

Trinidad and Tobago. Commercial banks provide home mortgage loans typically up to 75 percent loan-to-value ratio without default insurance. Higher LTVs are possible with mortgage insurance. However, approved mortgage companies, trust and mortgage companies, and life

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insurance companies may provide below-market, 30-year fixed rate loans up to 90 percent LTV without mortgage insurance.

Appendix H

Apex Housing Institution Involvement with Mortgage Insurance
The Experience of the U.S. Federal Home Loan Bank System

The Federal Home Loan Bank system (FHLB) has served as a central housing bank for the U.S. thrift (savings and loan) industry for over 60 years. Member FHLB thrift institutions have been, in many respects, comparable to India's housing finance companies. Until the early 1990s, when financial turmoil threatened the survival of the U. S. savings and loan industry and resulted in regulatory restructuring, the Federal Home Loan Bank functioned effectively as both thrift industry supervisor and liquidity source. (The S&L regulatory function has since been removed to another agency.) A key FHLB role has been to strengthen member liquidity through low-cost advances comparable to the NHB's refinance program. FHLB advances to members are secured by a pledge of members' mortgage loans.

There are a number of significant connections between mortgage default insurance and the role of the FHLB system as the apex housing institutions in the U.S. These connections include:

1. As regulator, the FHLB requires its thrift institution members to obtain mortgage default insurance on certain residential mortgage loans held in their own portfolios.

2. As founder of and former parent to a nationwide secondary market facility, the FHLB required by law that certain loans sold to that subsidiary operation carry mortgage default insurance. (This subsidiary agency – the Federal Home Loan Mortgage Corporation – was eventually spun off to public stockholders.)

3. Through its secondary market subsidiary (prior to spinoff), the FHLB became a *de facto* federal regulator of independent private mortgage insurance companies.

4. Through its secondary market facility the FHLB indirectly provided blanket guaranties against loss by reason of mortgage default to holders of mortgage-backed securities issued by its subsidiary agency.

5. Proposed national legislation in the late 1950s came very close to putting the FHLB directly into the business of providing mortgage default insurance for its members and other qualified lenders.

Each of these five apex institution-mortgage insurance connections is discussed further below.

1. In its role as regulator, the FHLB required its member thrift institutions to secure mortgage default insurance for certain classes of mortgage loans deemed high risk, i.e., those loans having minimum borrower equity. This insurance carrier had to be federally qualified (see below).

2. The most significant involvement of the FHLB with mortgage insurance, albeit indirect, occurred with the formation in 1971 of an FHLB subsidiary secondary market corporation, the

Federal Home Loan Mortgage Corporation, also known as Freddie Mac. Freddie Mac was chartered pursuant to federal legislation mandating establishment of a secondary market facility to purchase and securitize home loans made by FHLB member institutions (which collectively provided Freddie Mac's initial capitalization).

Freddie Mac's mission included: increased member liquidity; standardization of mortgage documentation; lower cost mortgage funds via access to capital markets through securitization; and better maturity matching for members. All these goals were largely achieved during the 1970s.

Loans purchased by Freddie Mac from its members thrift institutions initially took the form of mortgage participations, whereby the seller-servicer retained ownership of an undivided interest (i.e., a share of the risk exposure) in each loan sold. Member-retained participating interests evolved from an initially conservative 25 to 50 percent retention; lender-retained interests gradually decreased to 5 to 10 percent as the market matured. (Today, U.S. lenders no longer retain any direct interest in sold loans, but do retain exposure through extensive lending and servicing warranties and related recourse provisions.)

Of special significance to this report is the fact that the federal act creating Freddie Mac included explicit provisions relating to mortgage insurance, as well as guaranteed mortgage-backed securities. Low equity home mortgages purchased by Freddie Mac from its members were required to carry mortgage insurance, which was to be placed on the loan either at origination or at the point of sale to Freddie Mac.

3. Freddie Mac's role included the certification of mortgage insurance firms whose coverage would be approved for loans sold to Freddie Mac that required insurance. Such MI company certification amounted to *de facto* MI supervision, as Freddie Mac promulgated extensive operating and financial "eligibility requirements" for private mortgage insurers.

4. To finance its secondary market operations, Freddie Mac issued mortgage-backed securities called Participation Certificates or PCs. These securities carried a Freddie Mac guaranty of timely payment, which the market interpreted as an implicit, though not formal, guaranty by the U.S. government. Freddie Mac charged a guaranty fee as part of its "spread" and set aside loss reserve funds in support of its outstanding guarantees. Providing substantial support for the Freddie Mac guarantees, of course, were the lenders' warranties and recourse obligations and, in the case of high LTV loans, private mortgage insurance.

The closed-end set of relationships between the Federal Home Loan Bank System, its member thrift institutions specializing in housing finance, and Freddie Mac, its wholly-owned privately capitalized secondary market facility serving only FHLB members, changed markedly during the 1980s and 1990s. A much wider range of lenders can now become FHLB members and/or sell their loans to Freddie Mac. Notwithstanding these changes, however, the role of this U.S. apex housing institution with respect to mortgage default insurance has endured successfully to the present.

5. In 1957-58, the U.S. Congress – with strong backing from the thrift industry's national trade association – nearly passed a bill entitled the Home Loan Guaranty Corporation Act. Under this

act, a Home Loan Guaranty Corporation was to be established with substantial capital from regional Federal Home Loan Banks (in turn owned by member thrift institutions). Under the aegis of the Federal Home Loan Bank Board, broad powers were prescribed for this proposed new federal corporation. The proposed act authorized partial guarantees of principal on loans up to 90 percent loan-to-value plus partial or full guarantees of foreclosure costs and premium payments to sustain the program.

The narrow defeat of the bill was attributed mainly to concerns that it would compete with the existing Federal Housing Administration (FHA), which had been providing government mortgage insurance since the 1930s outside the sphere of an apex housing institution. A full copy of the Home Loan Guaranty Act, as proposed, appears in Appendix I.

Appendix I

Text of Proposed Home Loan Guaranty Act (U.S.)

85TH CONGRESS
1ST SESSION

S. 2791

IN THE SENATE OF THE UNITED STATES

AUGUST 14, 1957

Mr. SPARKMAN (by request) introduced the following bill; which was read twice and referred to the Committee on Banking and Currency

A BILL

Creating the Home Loan Guarantee Corporation.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Home Loan Guarantee
4 Corporation Act".
5 SEC. 2. Home Loan Guarantee Corporation herein re-
6 ferred to as the "Corporation" is hereby created and char-
7 tered as a corporation for the purposes herein stated.
8 SEC. 3. The Federal Home Loan Bank Board herein
9 referred to as the "Board" is authorized and directed to
10 prescribe bylaws, rules, and regulations not inconsistent with
11 this Act and to operate said Corporation.

I

1 SEC. 4. Said Board shall provide for the issuance of
2 $50,000,000 capital stock of the Corporation, divided into
3 shares of par value of $100 each. Upon the call of the
4 Board, the Federal home loan banks shall subscribe to such
5 capital, purchase, and pay for the same in proportion to the
6 par value of the outstanding capital of each Federal home
7 loan bank at the time of such call, but such capital shall
8 be issued in full shares and may be adjusted by said Board
9 and said banks shall purchase the same. Said stock shall
10 pay a cumulative dividend as determined by the Board
11 which shall be approximately one-half of 1 per centum in ex-
12 cess of the average dividend paid by the Federal home loan
13 banks and shall be retirable at par in the discretion of the
14 Board. A portion or all such stock may be so retired but
15 such retirement shall not be done so as to reduce the total
16 capital, reserves, and surplus of the Corporation below
17 $50,000,000, nor below that amount which in the opinion
18 of the Board is necessary or desirable to retain adequate
19 coverage of assumed risks outstanding.

20 SEC. 5. In addition to the capital issued to the Federal
21 home loan banks the Corporation is authorized to issue
22 the same type of capital stock to approved mortgagees as
23 herein defined provided they buy and maintain such stock
24 ownership, equivalent to one-seventh of 1 per centum of
25 the loans owned and the loans serviced by them and if,

1 as, and when stock is retired such stock shall be retired on
2 a pro rata basis. The Corporation shall adjust the issuance
3 and retirement of such stock to the nearest full $100 share.
4 SEC. 6. Approved mortgagee means a mortgagee to
5 which the Corporation has issued its certificate of approval
6 which is a bank, savings and loan association, or similar
7 institution or an insurance company or any other organiza-
8 tion engaged in the home mortgage business which has a
9 net worth of 1 per centum of the total of the home mort-
10 gages owned and serviced or $100,000, whichever is
11 greater, and which the Corporation finds to be experienced
12 and suitable for an approved mortgagee.
13 SEC. 7. Upon the date of enactment of this Act, the
14 Corporation shall become a body corporate, and shall be an
15 instrumentality of the United States and as such have
16 power—
17 (1) to adopt and use a corporate seal;
18 (2) to have succession until dissolved by Act of
19 Congress;
20 (3) to make contracts;
21 (4) to sue and be sued, complain and defend, in
22 any court of law or equity, State or Federal; and
23 (5) to appoint and to fix the compensation by the
24 Board, of such officers, employees, attorneys, or agents
25 as shall be necessary for the performance of its duties

1 under this title, without regard to the provisions of any
2 other laws relating to the employment or compensation
3 of officers or employees of the United States. Nothing
4 in this title or any other provision of law shall be con-
5 strued to prevent the appointment and compensation as
6 an officer, attorney, or employee of the Corporation, of
7 any officer, attorney, or employee of any board, corpo-
8 ration, commission, establishment, executive department,
9 or instrumentality of the Government. The Corpora-
10 tion, with the consent of any board, corporation, com-
11 mission, establishment, executive department, or instru-
12 mentality of the Government, including any field services
13 thereof, may avail itself of the use of information,
14 services, and facilities thereof in carrying out the pro-
15 visions of this title. The Corporation shall determine its
16 necessary expenditures under this Act, and the manner
17 in which the same shall be incurred, allowed, and paid,
18 without regard to the provisions of any other law gov-
19 erning the expenditure of public funds. All necessary
20 expenses in connection with the making of supervisory
21 or other examinations and the payment of guaranteed
22 losses including the provision of services and facilities
23 therefor, shall be considered as nonadministrative ex-
24 penses.
25 SEC. 8. For the purposes of this title, the Corporation

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1 shall have power to borrow money, and to issue notes, bonds,
2 debentures, or other such obligations upon such terms and
3 conditions as the Board may determine. Moneys of the Cor-
4 poration not required for current operation shall be deposited
5 in the Treasury of the United States, or upon the approval
6 of the Secretary of the Treasury, in any Federal Reserve
7 bank, or shall be invested in obligations of, or guaranteed
8 as to principal and interest by the United States. When
9 designated for that purpose by the Secretary of the Treasury,
10 the Corporation shall be a depository of public money under
11 such regulations as may be prescribed by the Secretary of
12 the Treasury, and may also be employed as fiscal agent of
13 the United States, and it shall perform all such reasonable
14 duties as depository of public money and fiscal agent as
15 may be required of it.

16 SEC. 9. All notes, bonds, debentures, or other such obli-
17 gations issued by the Corporation shall be exempt, both as
18 to principal and interest, from all taxation (except surtaxes,
19 estate, inheritance, and gift taxes) now or hereafter imposed
20 by the United States, by any Territory, dependency, or pos-
21 session thereof, or by any State, county, municipality, or local
22 taxing authority. The Corporation, including its franchise,
23 capital reserves, surplus, and income shall be exempt from
24 all taxation now or hereafter imposed by the United States,

S. 2791——2

1 by any Territory, dependency, or possession thereof, or by
2 any State, county, municipality, or local taxing authority;
3 except that any real property of the Corporation shall be
4 subject to State, Territorial, county, municipal, or local taxa-
5 tion to the same extent according to its value as other real
6 property is taxed.

7 SEC. 10. The Corporation shall make an annual report
8 of its operations to the Congress as soon as practicable after
9 the 1st day of January in each year. Said report may be a
10 part of the annual report of the Board.

11 SEC. 11. No individual, association, partnership, or cor-
12 poration shall use the words "Home Loan Guarantee Cor-
13 poration," or any combination of any of these words which
14 would have the effect of leading the public in general to
15 believe there was any connection, actually not existing,
16 between such individual association, partnership, or cor-
17 poration, and the Home Loan Guarantee Corporation, as
18 the name under which he or it shall hereafter do business.
19 No individual, association, partnership, or corporation shall
20 advertise or otherwise represent falsely by any device what-
21 soever that his or its mortgages are insured or in anywise
22 guaranteed by the Home Loan Guarantee Corporation, or
23 by the Government of the United States, or by any instru-
24 mentality thereof; and no insured mortgagee or holder shall
25 advertise or otherwise represent falsely by any device what-

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1 soever the extent to which or the manner in which his or
2 its mortgages are insured by the Home Loan Guarantee
3 Corporation. Every individual, partnership, association, or
4 corporation violating this subsection shall be punished by a
5 fine of not exceeding $1,000, or by imprisonment not ex-
6 ceeding one year, or both.

7 SEC. 12. The Corporation is authorized to borrow
8 money from any source, including the Federal home loan
9 banks and Federal Savings and Loan Insurance Corpora-
10 tion, and they are authorized to make loans to it upon such
11 terms and conditions as may be prescribed by the Board,
12 and the Corporation is authorized to use the facilities of
13 any other Government department or agency, including the
14 Federal home loan banks and Federal Savings and Loan
15 Insurance Corporation, and to pay reasonable compensation
16 therefor, and Government departments and agencies are
17 authorized to provide such facilities and services.

18 GUARANTY OF HOME MORTGAGES

19 SEC. 13. The Corporation is authorized to guarantee
20 home mortgages for any member of a Federal home loan
21 bank or approved mortgagee upon the terms and conditions
22 ~~herein stated and rules and regulations~~ made by the Board
23 not inconsistent herewith. Any member of a Federal home
24 loan bank or approved mortgagee desiring to have a home
25 mortgage guaranteed as herein provided shall submit an

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1 application as prescribed by the Board and attach thereto
2 a true copy of the obligation of the homeowner and the
3 security instrument and an appraisal of the security, and
4 the Corporation may prescribe the form for such appraisal
5 and it may require additional appraisal. Mortgages eligible
6 to be guaranteed hereunder may not be for a principal
7 amount in excess of 90 per centum of such appraisal and
8 shall be first mortgages on homes designed for single family
9 occupancy and occupied by the owner, or in good faith
10 intended for such occupancy in an original amount not in
11 excess of $20,000, amortized monthly, beginning not more
12 than twelve months from date, within twenty-five years.
13 The guaranty shall be for not in excess of 90 per centum
14 of 20 per centum of the amount of such mortgage. If at
15 any time said original indebtedness is paid down below 50
16 per centum of the original accepted appraisal of the security
17 for the loan, such insurance shall expire. If the loan is
18 not paid down to 50 per centum of the original approved
19 appraisal and the mortgagee forecloses, it shall give the
20 Corporation thirty days' notice before the institution of fore-
21 closure. Within such thirty days the Corporation shall ap-
22 praise or cause to be appraised the property securing the
23 mortgage and give consideration to the collectibility of the
24 debt from the security and from the obligor or obligors on
25 the mortgage. The Corporation shall within thirty days

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1 (a) pay the holder the amount invested in the mortgage
2 and take transfer of the same, or (b) pay the percentage
3 of the unpaid principal which is guaranteed in cash plus
4 any foreclosure costs and outlays, including attorneys' fees
5 which are guaranteed, or (c) pay the holder in cash the
6 amount guaranteed which is in excess of such foreclosure
7 appraisal if the holder is willing within thirty days to keep
8 the security and settle on that basis. The Corporation shall
9 also have power to compromise and settle any claim on its
10 guaranty.
11 The amount payable shall not exceed 90 per centum of
12 the principal remaining at the date of foreclosure or acquisi-
13 tion in lieu of foreclosure which is equivalent to the per-
14 centage of the original mortgage guaranteed. Any loss
15 resulting from failure of or defect in title or failure of the
16 holder to keep in force customary hazard insurance shall be
17 deducted from the amount otherwise payable for such guar-
18 anteed loss. Said guaranty shall be in favor of the original
19 holder of such mortgage and shall be for the benefit of such
20 original holder and any subsequent holder which is a mem-
21 ber of a Federal home loan bank, or approved mortgagee.
22 SEC. 14. The premium for such home mortgage guar-
23 anty shall be prescribed by the Board but shall not be less
24 than 5 per centum nor more than 10 per centum of the
25 amount by which such mortgage is guaranteed and shall be

1 payable in cash by the mortgagee or the mo tgagor at the
2 time the mortgage is guaranteed. Upon the p yment of such
3 premium, the Corporation shall issue its guar nty policy to
4 such mortgagee in the form prescribed by th Corporation.

5 SEC. 15. Open-end mortgages may be guaranteed as
6 provided in this Act but if any additional adva ices are made
7 before the guaranty expires, the guaranty sh ll expire un-
8 less a copy of the additional advance agre ment is for-
9 warded to the Corporation together with a premium for
10 the amount of such advance. If such advanc is made and
11 forwarded and the premium paid the mortgag shall remain
12 guaranteed for the percentage of the loan o iginally guar-
13 anteed until the debt is less than 50 per centum of the
14 original appraisal.

15 SEC. 16. The Board is authorized to disapprove any
16 such member institution or approved mortg gee for any
17 unsound practices as eligible to obtain such guaranty and
18 to prescribe general rules and regulations for the organiza-
19 tion and operation of said Corporation and o make such
20 requirements as may be reasonable and no inconsistent
21 with the Act. Without restricting the Boa d in making
22 general rules and regulations it is expressly authorized to

1 restrict the percentage of the total loans made in any
2 calendar year or the total percentage of its loan portfolio
3 which any member institution or approved mortgagee may
4 have guaranteed as provided in this Act.

5 SEC. 17. In addition to the guaranty of mortgages as
6 herein provided the Corporation is authorized to guarantee
7 any part or all of foreclosure costs and outlays including
8 attorneys fees on its guaranteed mortgages for an additional
9 premium on terms and conditions and for premiums pre-
10 scribed by it.

11 SEC. 18. The Corporation is authorized to require mem-
12 bers of the Federal home loan banks and other publicly
13 examined and supervised institutions to agree to make reports
14 and supply copies of reports of public examinations and of
15 public and private audits and to make their books and records
16 available to it and to permit it to examine. In the case of
17 other approved mortgagees the Corporation is authorized to
18 require them to agree to make reports, supply copies of
19 examinations and audits and to make their books and records
20 available to the Corporation for examination and to permit
21 such examination. In all cases such agreements may require
22 the mortgagee to agree to pay for the examinations and audits

1 reasonably necessary for the protection of the Co poration.

2 SEC. 19. If any provision of this Act, or the a plication

3 thereof to any person or circumstances, is held in alid, the

4 remainder of the Act, and the application of such provision

5 to other persons or circumstances, shall not be affected

6 thereby.

85TH CONGRESS
1ST SESSION

S. 2791

A BILL

Creating the Home Loan Guarantee Corporation.

By Mr. SPARKMAN

AUGUST 14, 1957

Read twice and referred to the Committee on Banking and Currency

Appendix J

Sample Master Policy Documents

This appendix contains representative samples of master policy documents used in the United States and in Australia by private mortgage insurance firms. These documents essentially define the business and insurance relationship between the mortgage insurance carrier and the insured lender.

The master policy describes the full terms and conditions of insurance liability, including procedures and obligations of the insured to secure and maintain coverage and to perfect a claim for loss in the event of borrower default.

Individual insured loans subject to a master policy are issued insurance certificates that identify the loan (e.g., borrower, property, loan, and specific coverage terms) and link it to the master policy. Coverage established under the master policy follows loans insured thereunder if and when such loans are transferred to a secondary market purchaser or placed in a securitized loan pool.

The two sample master policies that follow are:

1. **Mortgage Guaranty Insurance Corporation (MGIC),** the oldest and largest U.S insurer. The MGIC master policy has evolved over nearly 40 years of experience and changing conditions from a single page originally to nearly 20 pages at present.

2. **Commercial Union Australia Mortgage Insurance Corporation Limited (CUAMIC)**, one of the three leading private insurers in both Australia and New Zealand.

Mortgage Guaranty Insurance Corporation
250 E. Kilbourn Avenue
P.O. Box 488, Milwaukee, Wisconsin 53201

MGIC

Mortgage Guaranty Master Policy

Mortgage Guaranty Insurance Corporation (a stock insurance company hereinafter called the "Company") agrees to pay to the Insured identified below, in consideration of the premium or premiums to be paid as specified in this Policy and in reliance on the Insured's Application for coverage under this Policy any Loss due to the Default by a Borrower on a Loan, subject to the terms and conditions in this Policy.

Insured's Name and Mailing Address

Master Policy Number

SPECIMEN

Effective Date of Policy

In Witness Whereof, the Company has caused its Corporate Seal to be hereto affixed and these presents to be signed by its duly authorized officers in facsimile to become effective as its original seal and signatures and binding on the Company.

MORTGAGE GUARANTY INSURANCE CORPORATION

President

Secretary

Authorized Representative

Form #71-7135 (8/94)

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Terms and Conditions

1 Definitions

1.1 **Application** means a request for coverage, including assumption of coverage, under this Policy for a Loan on a form or in a format provided by the Company, and all other statements, documents or information furnished to the Company by the Insured or any other Person in connection with the insuring of the Loan. An application will include information, if so furnished to the Company, contained in the Borrower's Loan application, appraisal, verifications of income and deposit, plans and specifications for the Property, and all other exhibits and documents, and will include all data and information so furnished by electronic means.

1.2 **Appropriate Proceedings** means any legal or administrative action by the Insured affecting either a Loan or title to a Property, including:

a. Preserving a deficiency recovery by making a bid at the foreclosure sale and pursuing a deficiency judgment until the end of the Settlement Period, where appropriate and permissible and where directed by the Company; or

b. Enforcing the terms of the Loan as allowed by the laws where the Property is located; or

c. Acquiring Borrower's Title or Good and Merchantable Title to the Property, as either may be required under this Policy, but excluding such title as may be acquired by a voluntary conveyance from the Borrower; or

d. Asserting the Insured's interest in the Property in a Borrower's bankruptcy.

1.3 **Borrower** means any Person legally obligated to repay the debt obligation created by a Loan, including any co-signer or guarantor of the Loan.

1.4 **Borrower's Title** means such title to a Property as was vested in the Borrower at the time of a conveyance to the Insured arising out of or pursuant to a foreclosure of the Loan; provided, however, if the Insured so elects, the redemption period need not have expired. Borrower's Title in the Insured may be, but need not be the equivalent of Good and Merchantable Title, and the deed evidencing Borrower's Title need not be recorded unless required by applicable law.

1.5 **Certificate** means the document, which may be on the same form as the Commitment, issued by the Company pursuant to this Policy and extending the coverage indicated therein to a specified Loan.

1.6 **Certificate Effective Date** means, as specified in the Certificate, (a) the closing date of a Loan, or (b) the later date requested by the Insured and accepted by the Company.

1.7 **Claim** means the timely filed written request, made on a form or in a format provided or approved by the Company, to receive the benefits of this Policy.

1.8 **Claim Amount** means the amount calculated in accordance with Section 6.2 of this Policy.

1.9 **Commitment** means the document, which may be on the same form as the Certificate, issued by the Company evidencing the Company's offer to insure the Loan identified therein, subject to the terms and conditions therein and in this Policy.

1.10 **Default** means the failure by a Borrower (a) to pay when due an amount equal to or greater than one (1) monthly regular periodic payment due under the terms of a Loan or (b) to pay all amounts due on acceleration of the Loan by the Insured after breach by the Borrower of a due on sale provision in the Loan, granting the Insured the right to accelerate the Loan upon transfer of title to, or an interest in, the Property and to institute Appropriate Proceedings. Violation by the Borrower of any other term or condition of the Loan which is a basis for Appropriate Proceedings shall not be considered to be a Default.

A Loan is deemed to be in Default for that month as of the close of business on the installment due date for which a scheduled monthly payment has not been made or as of the close of business on the due date stated in the notice of acceleration given pursuant to the due-on-sale provision in the Loan. The Loan will be considered to remain in Default until filing of a Claim so long as such periodic payment has not been made or such basis for Appropriate Proceedings remains. For example, a Loan is "four (4) months in Default" if the monthly installments due on January 1 through April 1 remain unpaid as of the close of business on April 1 or if a basis for acceleration and Appropriate Proceedings exists for a continuous period of four months.

1.11 **Environmental Condition** means the presence of environmental contamination, including nuclear reaction or radioactive waste, toxic waste, or poisoning, contamination or pollution of earth or water subjacent to the Property or of the atmosphere above the Property; or the presence, on or under a Property, of any "Hazardous Substance" as that term is defined by the federal Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. Sec. 9601 et. seq., as amended from time to time) or as defined by any similar state law, or of any "Hazardous Waste" or "Regulated Substance" as those terms are defined by the federal Resource Conservation and Recovery Act (42 U.S.C. sec. 6901, et seq., as amended from time to time) or as defined by any similar state law. Environmental Condition does not mean the presence of radon, lead paint, or asbestos.

1.12 **Good and Merchantable Title** means title to a Property free and clear of all liens, encumbrances, covenants, conditions, restrictions, easements and rights of redemption, except for any of the following or as permitted in writing by the Company:

a. Any lien established by public bond, assessment or tax, when no installment, call or payment of or under such bond, assessment or tax is delinquent;

b. Any municipal and zoning ordinances and exceptions to title waived by the regulations of federal mortgage insurers and guarantors with respect to mortgages on one-to-four family residences in effect on the date on which the Loan was closed and all documents were executed; and

c. Any other impediments which will not have a materially adverse effect on either the transferability of the Property or the sale thereof to a bona fide purchaser.

Good and Merchantable Title will not exist if (i) there is any lien pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act, or similar federal or state law, as in effect from time to time, providing for liens in connection with the removal and clean-up of environmental conditions, or if notice has been given of commencement of proceedings which could result in such a lien, or (ii) there are limitations on ingress and egress to the Property or on use of utilities. Any action or proceeding after a foreclosure sale relating to establishing a deficiency judgment will not be considered in determining whether the Insured has acquired Good and Merchantable Title.

1.13 **Insured** means:

a. The Person designated on the face of this Policy; or

b. Any Person to whom coverage has been assigned resulting in a change in the Insured named on a Certificate in accordance with this Policy.

The Insured must be the Servicer of a Loan or, if there is no Servicer, the Owner of the Loan.

1.14 **Loan** means any note, bond, or other evidence of indebtedness secured by a mortgage, deed of trust, or other similar instrument, which constitutes or is equivalent to a first lien or charge on a Property and which the Company has approved for insurance and to which coverage under this Policy has been extended.

1.15 **Loss** means the liability of the Company with respect to a Loan for payment of a Perfected Claim which is calculated in accordance with Section 6.3. A Loss will be deemed to have occurred when a Default on a Loan occurs, even though the amount of Loss is not then either presently ascertainable or due and payable.

1.16 **Owner or Owner of the Loan** means the Person who owns a Loan and of whom the Company is notified in accordance with this Policy.

1.17 **Perfected Claim** means a Claim received by the Company which contains all information or proof required by the Company and for which all requirements of this Policy applicable to payment of a Claim are satisfied.

1.18 **Person** means any individual, corporation, partnership, association or other entity.

1.19 **Physical Damage** means any tangible injury to a Property, whether caused by accident, natural occurrence, or any other reason, including damage caused by defects in construction, land subsidence, earth movement or slippage, fire, flood, earthquake, riot, vandalism or any Environmental Condition.

1.20 **Policy** means this contract of insurance and all Applications, Commitments, endorsements, schedules, and Certificates, which are incorporated in this Policy, related to Loans insured under this Policy.

1.21 **Possession of the Property** means, if the Company elects to acquire the Property, physical and undisputed occupancy and control of the Property at the time of acquisition.

1.22 **Property** means a Residential real property and all improvements thereon which secure a Loan, together with all easements and appurtenances, all rights of access, all rights to use common areas, recreational and other facilities, and all of their replacements or additions.

1.23 **Residential** means a type of building or a portion thereof which is designed for occupancy by not more than four (4) families, or a single-family condominium, or a unit in a planned unit development.

1.24 **Servicer** means that Person acting on behalf of the Owner of a Loan (or on behalf of the Owner's designee, if any) to service the Loan and of whom the Company has been notified. The Servicer acts as a representative of the Owner of the Loan (and the Owner's designee, if any) and will bind the Owner and its designee for all purposes of this Policy, including providing information to the Company, receiving any notices, paying premiums, accepting Loss payments, and performing any other acts under this Policy. References in this Policy to a Servicer's obligations will not be construed as relieving the Owner or its designee of responsibility for the Servicer's performance.

1.25 **Settlement Period** means the sixty (60) day period as determined under Section 6.4, at the end of which a Loss is payable by the Company; provided that if the Company pays a Loss prior to expiration of such sixty (60) day period, the Settlement Period ends with such payment.

1.26 **Value** means the lesser of the sales price of a Property (only applicable in the case of a Loan to finance the purchase of such Property) or appraised value of the Property as set forth in the Certificate.

Any pronouns, when used in this Policy, will mean the singular or plural, masculine or feminine, as the case may be.

Obtaining Coverage and Payment of Premiums

2.1 **Application and Certificate** — In order to insure a Loan under this Policy, the Insured or a Person acting on behalf of the Insured must submit to the Company a properly completed Application. Approval of any Application will be at the discretion of the Company and will be in the form of a Commitment or a ~~Certificate which offers to~~ extend, or extends coverage under the terms and conditions of both this Policy and the Commitment or Certificate, as the case may be.

In lieu of such an Application and supporting statements, documents and information submitted to the Company in connection with insuring a Loan, the Company may accept an alternative form of Application, containing more limited information, including certifications by or on behalf of the Insured as to characteristics of a Loan in lieu of supporting statements, documents and information. The Company shall be entitled to fully rely on such alternative Application as submitted. Use of an alternative form of Application shall not waive or change the other terms and conditions of this Policy under which a Loan is insured or the responsibility of the Insured for the

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accuracy of statements, documents and information submitted by it or other Persons to the Company as provided in this Policy.

If the Company declines to approve a mortgage loan, it will not issue a Commitment or Certificate, and it will notify the Insured in writing of such declination. If the Insured or the Person acting on its behalf subsequently denies the mortgage loan application which it received from the applicant, the Insured or such Person will be responsible for notifying the applicant that the Company declined to approve the mortgage loan. Such notification will be made in compliance with any applicable state or federal laws or regulations, including the Equal Credit Opportunity Act and any other similar law or regulation.

2.2 **Representations of the Insured** — The Insured represents that:

a. all statements made and information provided to the Company in an Application or in any Commitment or Certificate (including as such is related to continuation of coverage upon assumption of a Loan), whether by it, the Borrower, or any other Person, have been made and presented for and on behalf of the Insured; and

b. such statements and information are not false or misleading in any material respect as of the date(s) on which they are made or provided and do not omit any fact necessary in order to make such statements and information not false or misleading in any material respect as of such date(s).

It is understood and agreed that such statements and information in the aggregate are, and in certain instances individually may be, material to the Company's decision to offer, provide or so continue coverage of the related Loan; the Company issues the related Commitment and Certificate or continues coverage in reliance on the accuracy and completeness of such statements and information and without any obligation to independently verify the statements and information submitted to it; and the Company's reliance on the representations in Section 2.2(a) and (b) above survive the issuance of a Commitment and Certificate or such continuation of coverage.

Without otherwise limiting the scope of this Section 2.2, a breach of Section 4.8 relating to down payment will be deemed a material misrepresentation for purposes of this Section 2.2. The foregoing representations shall be effective whether or not they are made by the Insured or other Person with the intent to deceive or mislead, or with the knowledge that they are not true and correct.

2.3 **Company's Remedies for Misrepresentation** — Subject to Section 2.4, if any of the Insured's representations as described in Section 2.2 are materially false or misleading with respect to a Loan, the Company will have at its option, the right to defend against a Claim, or to the extent permitted by applicable law, to cancel or rescind coverage under any Certificate retroactively to commencement of coverage (or if the misrepresentation occurs with respect to continuation of coverage upon assumption of a Loan, to so defend, cancel or rescind retroactively to the date of such continuation). In the case of such cancellation or rescission, the Company shall return at that time all paid premiums retroactively to such applicable date.

2.4 **Incontestability for Certain Misrepresentations** — Notwithstanding Sections 2.2 or 2.3, no Claim for Loss will be denied or adjusted, nor will the Certificate's coverage be rescinded or canceled, by reason of any misrepresentations (whether by statements made or omitted) contained in an Application, provided that all of the following requirements, conditions and circumstances, to the extent not waived in writing at the option of the Company, are satisfied:

a. The misrepresentation must not have been knowingly made, or knowingly participated in, by:

1. The Insured or any other Person which originated the Loan; or

2. Any other of the following Persons:

i) correspondent lender, mortgage loan broker or other intermediary underwriting or processing the Loan on behalf of the Insured or any other Person which originated the Loan, or

ii) escrow or closing agents, or any other agent of, or broker for, the Insured or any other Person which originated the Loan acting with respect to the Loan or the related Property transaction.

b. The Borrower must have made twelve (12) consecutive full installment payments of principal, interest and impound or escrow amounts in the amounts as called for by the Loan, and all of those payments must have been made from the Borrower's own funds.

A payment will be considered to be "consecutive" only if it is made prior to the date the next scheduled installment becomes due. The "Borrower's own funds" will include any funds used by the Borrower for the purpose of making installment payments, but will not include funds provided directly or indirectly by any Person (other than the Borrower) who is or was a party to the Loan or to the related Property transaction, unless expressly set forth in the Application.

c. This Section 2.4 will not apply to a Certificate if within twelve (12) months before or after a material misrepresentation by a Borrower or other Person (other than those Persons identified in Section 2.4(a)), there are one or more material misrepresentations in an Application (i) with respect to three (3) or more other mortgage loans insured at any time by the Company for the Insured or any other lender and (ii) which result from the direct or indirect acts or omissions of the same Borrower or same other Person (including any other Person acting directly or indirectly in concert).

d. This Section 2.4 shall not be construed to limit the applicability of Section 4.4(b) to a misrepresentation which is subject to this Section 2.4.

e. The Company's payment of a Claim will not limit any rights which the Company has against the Borrower or any other Person (other than the Insured) for any misrepresentation.

2.5 Initial Premium and Term of Coverage

a. Within fifteen (15) days from the Certificate Effective Date, or such other date as the Company and the Insured may agree to in writing, the Insured must forward to the Company the appropriate initial premium. Payment of the initial premium shall be a condition precedent to coverage being extended to the Loan. Subject to cancellation by the Insured or the Company as provided in this Policy, coverage shall remain in full force and effect for the period covered by the initial premium. Tender of the initial premium will constitute a representation for purposes of Section 2.2 by the Insured that any special conditions included by the Company in the related Commitment have been satisfied and that no payment which is then due under the Loan is more than thirty (30) days past due.

b. The Company will not rescind or cancel coverage, or deny or adjust a Claim for Loss, with respect to a Loan on the basis of a failure to satisfy a special condition (other than a special condition relating to completion of construction, as described in Section 4.3 or to rehabilitation or repairs) if the Borrower has made twenty-four (24) consecutive full installment payments from the Borrower's own funds. The terms "installment payments," "consecutive," and "Borrower's own funds" shall have the meanings provided in Section 2.4(b).

2.6 Renewal of Certificate and Termination for Non-Payment of Renewal Premium; Reinstatement of Terminated Coverage

a. The Company must give the Insured prior notice of the due date for payment of the applicable renewal premium payable for continued coverage of each Certificate. The entire renewal premium must be paid within a forty-five (45) day grace period (or such longer grace period generally allowed by the Company) after the due date for payment. Upon payment of the entire renewal premium within such grace period, the Certificate will be deemed renewed for the applicable renewal period and a Default occurring within said grace period which is not cured, and which results in a Claim being filed, will be covered.

If a Default occurs prior to the date through which the applicable premium has been paid, and if such Default is not cured and results in a Claim being filed, such Default shall remain covered and no further premium shall be due in order to maintain coverage of such Default.

With respect to a Loan with renewal premiums due on an annual basis, if the annual renewal premium is not paid within such grace period (but subject to the Owner's right to cure non-payment as provided in (b) of this Section 2.6), the coverage of the Certificate and the Company's liability will terminate effective as of 12:01 a.m. on the first day following the date through which the applicable premium has been paid and as a result, any Default occurring after the date through which the applicable premium has been paid will not be covered.

With respect to a Loan with renewal premiums due on a monthly basis, if the monthly renewal premium is not paid within such grace period (but subject to the Owner's right to cure non-payment as provided in (b) of this Section 2.6), the coverage of the Certificate and the Company's liability will terminate as of 12:01 a.m. on the first day following the date through which the applicable monthly premium has been paid, except that if a Default on the Loan occurs between the last date through which the applicable monthly renewal premium has been paid and the end of such grace period, the Insured shall not be required to pay renewal premiums, and coverage of such Default will continue, while such Default exists. If such Default is cured, all monthly renewal premiums not paid during the period of Default shall be payable (unless previously paid by the Insured) within forty-five (45) days or such longer period generally allowed by the Company after notice from the Company in order to continue coverage. If such Default is not cured and results in a Claim, the unpaid monthly renewal premiums through the renewal month in which such Default occurred shall be paid as provided in Section 6.3 by deduction from the Loss.

b. If there occurs a transfer of servicing rights for a group of Loans to a new Servicer, a seizure of servicing rights by the Owner of such Loans, or a Servicer's surrender to the Owner of such servicing rights and if:

1. the Company terminates coverage on one or more of such Loans for nonpayment of the renewal premium; and the grace period for payment of the renewal premium provided for in Section 2.6 (a) expired after such transfer, seizure or surrender;

2. either the Owner of such Loans on which coverage was terminated, or the new Servicer for such Loans, certifies in writing to the Company within sixty (60) days after expiration of such grace period, that all of such Loans were serviced for the Owner at the time of nonpayment of renewal premium; and that in good faith it believes that the failure to pay the renewal premium on all such Loans was an error or omission caused by such transfer, seizure or surrender of servicing; and

3. either the Owner or the new Servicer of such Loans pays the entire amount of renewal premiums due and unpaid on all such Loans within such sixty day period; then

upon satisfaction of all of the foregoing conditions, the Company shall reinstate coverage on such Loans retroactively to the effective date of termination of coverage, under all of the terms and conditions in effect at termination and as if there had been no lapse in coverage.

2.7 Special Procedures for Certification of Coverage; Payment of Initial and Renewal Premiums

a. The Company may permit coverage of a Loan to be certified and become effective without the Insured's return of an executed Commitment or Certificate, but coverage will only become effective if within fifteen (15) days after the Certificate Effective Date (or such longer period as the Company may allow) the Insured provides the Company with the Certificate Effective Date and other information required by the Company, and pays the required premium. If signature and return of an executed Commitment or Certificate is not required, the Insured will nevertheless be automatically deemed to have made all certifications, representations and statements attributable to it in the form of the Commitment or Certificate, as though, and to the same extent as if, the Insured had executed and returned the Commitment or Certificate.

b. The Insured acknowledges that the Company deposits initial and renewal premium checks immediately upon receipt and agrees that the receipt and deposit of a premium check by the Company after the time specified in this Policy for receipt, does not constitute a waiver of the requirements of this Policy for timely receipt or an acceptance of premium by the Company. The Company will have the right to return such late premium payment, but only within sixty (60) days after receipt, in which case coverage will be cancelled retroactively

to the Certificate Effective Date for a late initial premium, or to the last day of the period covered by the previous premium payment for a late renewal premium. Receipt, deposit and retention of a premium check will not constitute a waiver of any defenses with respect to any other matters which the Company may have under this Policy.

2.8 **Cancellation by the Insured of a Certificate** — The Insured may obtain cancellation of a Certificate by returning the Certificate to the Company or making a written request to the Company for cancellation. Upon receipt, the Company will refund, where applicable, a portion of the premium paid in accordance with the appropriate cancellation schedule which is either attached to this Policy or which will be provided by the Company to the Insured upon request. However, no refund on a Certificate will be paid if the Loan is in Default on the date the Company receives the request. Cancellation of a Certificate will not cancel this Policy.

2.9 **Cancellation of Policy** — Either the Insured or the Company may cancel their respective right or obligation to receive or issue new Commitments or Certificates under this Policy by providing thirty (30) days' written notice of cancellation of this Policy. However, Commitments and Certificates issued prior to such cancellation of this Policy will continue in force so long as all premiums are paid and all other terms and conditions of this Policy for coverage are complied with by the Insured.

2.10 **Relationship Among the Company, the Owner of a Loan, and the Servicer of a Loan** — The Company will be entitled to assume that the Insured identified on this Policy and under a Certificate is the Owner of the Loan. If the Company receives written notice acceptable to it that there is an Owner of the Loan who is not the Insured, the Company shall identify that Owner in its internal records and for purposes of this Policy. The Company shall be required to identify only one Owner for a Loan at any one time.

The Company will provide the Owner of a Loan so identified in its records with an opportunity to cure non-payment of renewal premium, as provided under Section 2.6; will notify such Owner of the Loan of a non-approved Servicer and allow replacement with a new Servicer, as provided under Section 4.5; will allow the Owner (or its designee, if any) to replace a Servicer and allow the replacement Servicer to become the Insured under Section 1.13; and will allow the Owner to become the Insured under Section 1.13 if the Owner services the Loan itself. Any Person becoming an Insured under this Policy shall be subject to all of the terms and conditions of this Policy to the same extent as any previous Insured hereunder and without regard to the extent of the knowledge or responsibility of such Person, relating to matters occurring before such Person became an Insured.

2.11 **Refund of Premium for Denial of Claim in Full** — If, because of a provision in Sections 2, 3 or 4 (other than Sections 4.3, 4.6, or 4.7), no Loss is payable to the Insured, the Company shall return to the Insured all paid premiums retroactively and pro rata to the date when the event or circumstance occurred which resulted in no Loss being payable.

Changes in Various Loan Terms, Servicing and Owner; Co-ordination and Duplication of Insurance Benefits

3.1 **Loan Modifications** — Unless advance written approval is provided by, or obtained from, the Company, the Insured may not make any change in the terms of a Loan, including the borrowed amount, interest rate, term or amortization schedule of the Loan, except as permitted by terms of the Loan; nor make any change in the Property or other collateral securing the Loan; nor release the Borrower from liability on a Loan.

3.2 **Open End Provisions** — The Insured may increase the principal balance of a Loan, provided that the written approval of the Company has been obtained. The Insured will pay the Company the additional premium due at the then prevailing premium rate.

3.3 **Assumptions** — If a Loan is assumed with the Insured's approval, the Company's liability for coverage under its Certificate will terminate as of the date of such assumption, unless the Company approves the assumption in writing. The Company will not unreasonably withhold approval of an assumption. It is understood that coverage will continue, and that the restriction of this Section 3.3 will not apply, if under the Loan or applicable law the Insured cannot exercise a "due-on-sale" clause or is obligated to consent to such assumption under the Loan or applicable law.

3.4 **Change of Servicing** — If the servicing rights for a Loan are sold, assigned or transferred by the Insured or the Owner, coverage of the Loan hereunder will continue provided that written notice of the new Servicer is given to the Company and the new Servicer is approved in writing by the Company. The Company shall be automatically deemed to have approved as a Servicer any person to whom the Company has issued a master policy, which has not been cancelled, providing for residential mortgage guaranty insurance.

3.5 **Change of Owner** — If a Loan or a participation in a Loan is sold, assigned or transferred by its Owner, coverage of the Loan will continue, subject to all of the terms and conditions contained in this Policy. The new Owner of the Loan will be identified in the Company's records from the date that the Company receives written notice thereof. In the case of the sale of a participation in a Loan, the Company shall be notified of only one new Owner. If there is new ownership, the Loan must continue to be serviced by a Person approved by the Company as a Servicer.

3.6 **Co-ordination and Duplication of Insurance Benefits** — The coverage under this Policy shall be excess over any other insurance which may apply to the Property or to the Loan, except for mortgage guaranty pool insurance or supplemental or second tier mortgage insurance.

Exclusions From Coverage

The Company will not be liable for, and this Policy will not apply to, extend to or cover the following:

4.1 **Balloon Payment** — Any Claim arising out of or in connection with the failure of the Borrower to make any payment of principal and/or inte[illegible]e under a Loan, (a) as a result of the Insured exercising its right to call the Loan (other than when the Loa[illegible]efault) or because the term of the Loan is shorter than the amortization period, and (b) which is for an [illegible] more than twice the regular periodic payments of principal and interest that are set forth in the Loan (commonly referred to as a "balloon payment"). This exclusion will not apply if the Insured, the Owner of the Loan, or other Person acting on either's behalf offers the Borrower, in writing, a renewal or extension of the Loan or a new loan which (i) constitutes a first lien, (ii) is at rates and terms generally prevailing in the marketplace (but otherwise subject to Section 3.1), (iii) is in an amount not less than the then outstanding principal balance, (iv) has no decrease in the amortization period, and (v) is offered regardless of whether the Borrower is then qualified under the Insured's or Owner's underwriting standards. This exclusion also will not apply if the Borrower is notified of the availability of such renewal or extension of the Loan or new loan and does not accept the renewal, extension or new loan.

4.2 **Effective Date** — Any Claim resulting from a Default existing at the Certificate Effective Date or occurring after lapse or cancellation of a Certificate.

4.3 **Incomplete Construction** — Any Claim when, as of the date of such Claim, construction of a Property is not completed in accordance with the construction plans and specifications upon which the appraisal of the Property at origination of the Loan was based.

4.4 **Fraud, Misrepresentation and Negligence** — (a) Any Claim not otherwise within the scope of Section 2.3 where there was fraud or misrepresentation by the Insured with respect to the Loan, and the fraud or misrepresentation (1) materially contributed to the Default resulting in such Claim; or (2) increased the Loss, except that if the Company can reasonably determine the amount of such increase, such Claim will not be excluded, but the Loss will be reduced to the extent of such amount.

(b) Any Claim where there was negligence by the Insured with respect to the Loan, which (1) was material to either the acceptance of the risk or the hazard assumed by the Company; (2) materially contributed to the Default resulting in such Claim; or (3) increased the Loss, except that if the Company can reasonably determine the amount of such increase, such Claim will not be excluded, but the Loss will be reduced to the extent of such amount.

4.5 **Non-Approved Servicer** — Any Claim occurring when the Servicer, at time of Default or thereafter, is not approved in writing or in a list published by the Company; provided that this exclusion shall only apply if the Company notifies the Owner of the Loan in writing if a Servicer is no longer approved and if within ninety (90) days thereafter the Owner does not complete a transfer of servicing to a new Servicer approved by the Company

4.6 **Physical Damage (Other than Relating to Pre-Existing Environmental Conditions)** — Any Claim where, at any time after the Certificate Effective Date, Physical Damage to a Property (of a type other than as described in Section 4.7 and other than reasonable wear and tear), occurs or manifests itself subject to the following provisions:

a. This exclusion will not apply if the Company in good faith determines that the aggregate cost of restoring all such Physical Damage is less than fifteen hundred dollars ($1,500), or such higher amount as the Company may provide from time to time.

b. This exclusion will apply only if such Physical Damage occurred or manifested itself (1) prior to expiration of the Settlement Period and the Company elects to acquire the related Property in settlement of a Claim; or (2) prior to the Default and was the most important cause of the Default and the Property was either uninsured for loss arising from such Physical Damage or was insured for an amount which, disregarding normal and customary deductibles not to exceed fifteen hundred dollars ($1,500) or such higher amount as the Company may provide from time to time, was insufficient to restore the Property as provided in paragraph (c) below.

c. The exclusion resulting from paragraph (b) will not apply if the Property is restored in a timely and diligent manner to its condition (except reasonable wear and tear) as of the Certificate Effective Date. In lieu of requiring restoration of the Property, the Company may, at its option, reduce the Claim Amount by an amount equal to the cost of such restoration.

d. For purposes of this Section 4.6, the Property subject to restoration will consist only of the land, improvements or personal property deemed part of the real property under applicable law; and chattel items affixed to the real property and identified in the appraisal of the Property at the time the Loan was made, whether or not they are deemed part of the real property.

e. Cost estimates relied upon by the Company in connection with this Section 4.6 shall be provided in writing by an independent party selected by the Company. The Company will furnish the Insured with any such written cost estimates, if requested by the Insured.

4.7 **Pre-Existing Environmental Conditions** — Any Claim where there is an Environmental Condition which existed on the Property (whether or not known by the Person submitting an Application for coverage of the Loan) as of the Certificate Effective Date, subject to the following provisions:

a. This exclusion will not apply if the existence of such Environmental Condition, or the suspected existence of such Environmental Condition, was specifically disclosed to the Company in the Application relating to the Property.

b. This exclusion will apply only if such Environmental Condition (1) was a principal cause of the Default, and (2) has made the principal Residential structure on the Property uninhabitable. A structure will be considered "uninhabitable" if generally recognized standards for residential occupancy are violated or if, in the absence of such standards, a fully informed and reasonable person would conclude that such structure was not safe to live in without fear of injury to health or safety.

c. This exclusion will not apply if the Environmental Condition is removed or remedied in a timely and diligent manner in accordance with applicable governmental standards for safe residential occupancy.

4.8 **Down Payment** — Any Claim involving a Loan which is for the purchase of the Property, and for which the Borrower did not make a down payment as described in the Application.

4.9 **First Lien Status** — Any Claim, if the mortgage, deed of trust or other similar instrument executed by the Borrower and insured hereunder did not provide the Insured at origination with a first lien on the Property.

4.10 **Breach of the Insured's Obligations or Failure to Comply with Terms** — Any Claim involving or arising out of any breach by the Insured of its obligations under, or its failure to comply with the terms of, this Policy or of its obligations as imposed by operation of law, if the breach or failure:

a. Materially contributed to the Default resulting in such Claim; or

b. Except for a breach described in Section 2.3, increased the Loss; provided that if the Company can reasonably determine the amount of such increase, such Claim will not be excluded, but the Loss will be reduced to the extent of such amount.

Conditions Precedent to Payment of Claim

It is a condition precedent to the Company's obligation to pay a Loss that the Insured comply with all of the following requirements:

5.1 **Notice of Default** — The Insured must give the Company written notice:

a. Within forty-five (45) days of the Default, if it occurs when the first payment is due under the Loan; or

b. Within ten (10) days of either

1. The date when the Borrower becomes four (4) months in Default on the Loan; or

2. The date when any Appropriate Proceedings which affect the Loan or the Property or the Insured's or Borrower's interest therein have been started;

whichever occurs first.

5.2 **Monthly Reports** — Following a notice of Default on the Loan, the Insured must give the Company monthly reports on forms or in a format acceptable to the Company on the status of the Loan and on the servicing efforts undertaken to remedy the Default. These monthly reports may be furnished less frequently if allowed in writing by the Company and must continue until the Borrower is no longer in Default, the Appropriate Proceedings terminate, or until the Insured has acquired the Property.

5.3 **Company's Option to Accelerate Filing of a Claim** — If the Company so directs, at any time after receiving the Insured's notice of Default, the Insured must file a Claim within twenty (20) days after notice from the Company. The Company will then make a payment of Loss in accordance with the percentage guaranty option in Section 6.3(b). Thereafter, following the acquisition of Borrower's Title by the Insured, the Insured will be entitled to file a supplemental Claim at the time prescribed in Section 6.1 in an amount equal to the sum of its advances, less the deductions, all as specified in Section 6.2, to the extent not included in the payment of the initial Claim. Such supplemental Claim must be paid by the Company in accordance with Section 6.3(b). No interest shall be includable in the Claim Amount under this Section 5.3 after the date that the accelerated claim is filed. If a Loan for which the Company has paid a Claim is subsequently brought current by the Borrower, the Insured shall refund to the Company the Loss paid by the Company with respect to that Loan. If the Company exercises its option under this Section 5.3, the Company shall not have the right to direct or participate in a deficiency recovery under Section 7.2.

5.4 **Voluntary Conveyance** — The Insured may only accept a conveyance of the Property from the Borrower in lieu of foreclosure or other proceeding if the prior written approval of the Company has been obtained. Such approval shall not be considered as an acknowledgement of liability by the Company with respect to such Loan.

5.5 **Appropriate Proceedings** — The Insured must begin Appropriate Proceedings no later than when the Loan becomes six (6) months in Default unless the Company provides written instructions that some other action be taken. Such instructions may be general or applicable only to specific Loans. The Company reserves the right to direct the Insured to institute Appropriate Proceedings at any time after Default. When either defending against or bringing Appropriate Proceedings, the Insured must report their status to the Company as reasonably and expeditiously as possible.

In conducting Appropriate Proceedings, the Insured must:

a. Diligently pursue the Appropriate Proceedings once they have begun;

b. Apply for the appointment of a receiver and assignment of rents, if permitted by law and requested by the Company;

c. Furnish the Company with copies of all notices and pleadings filed or required in the Appropriate Proceedings, except as the Company may waive such requirement in writing;

d. Act and bid at the foreclosure sale in accordance with Section 5.11 so that its ability to preserve, transfer and assign to the Company its rights against the Borrower are not impaired; and so that the rights of the Company under this Policy against the Borrower are fully protected. Such rights include any rights to obtain a deficiency judgment, subject to the Company's compliance with Sections 7.2 and 7.3 relating to establishing a deficiency; and

e. When requested by the Company, furnish the Company with a written statement indicating the estimated potential Claim Amount (as computed under Section 6.2) at least fifteen (15) days before the foreclosure sale.

5.6 **Mitigation of Damages** — The Insured must actively cooperate with and assist the Company to prevent and mitigate the Loss, including good faith efforts by the Insured to obtain a cure of the Default, collect amounts due under the Loan, inspect and appraise the Property and effectuate the early disposition of the Property. The Company must administer this Policy in good faith.

5.7 **Advances** — The Insured must advance:

a. Normal and customary hazard insurance premiums and real estate property taxes, in each case as due and payable;

b. Reasonable and necessary Property protection and preservation expenses approved by the Company at the time the Company reviews the Claim, which shall not include expenditures to remove an exclusion from coverage under Section 4; and

c. Reasonable costs to complete Appropriate Proceedings and eviction and moving of occupants, including related court expenses and attorney's fees.

5.8 **Claim Information and Other Requirements** — The Insured must provide the Company with:

~~a. All information reasonably requested by the Company;~~

b. A completed form furnished by or acceptable to the Company for payment of a Claim;

c. If the Property is not being acquired by the Company: a copy of an executed trustee's or sheriff's deed (which may be unrecorded) conveying Borrower's Title to the Property to the Insured (or satisfactory evidence that the foreclosure sale has been completed if the Borrower's right of redemption has not expired); or a deed from the Borrower (which may be unrecorded) if a voluntary conveyance has been approved by the Company, conveying to the Insured the title that was required by the Company in the approval of he conveyance.

In the event the most important cause of Default was a circumstance or event which would prevent the Insured from obtaining Good and Merchantable Title, the Insured shall instead provide the Company with evidence described in Section 5.8(d)(2) that it has acquired Good and Merchantable Title to the Property.

d. If the Property is being acquired by the Company:

1. a recordable deed in normal and customary form containing the customary warranties and covenants conveying to the Company or its designee Good and Merchantable Title to the Property;

2. a title insurance policy acceptable to the Company or an attorney's opinion of title acceptable to the Company, confirming that the Insured has and can convey to the Company Good and Merchantable Title to the Property; and

3. Possession of the Property, but only if the Company has required such Possession in writing.

e. Access to the Property, if requested by the Company under Section 6.4 (b).

5.9 **Acquisition of Borrower's Title Not Required —** The Insured will not be required to acquire Borrower's Title to a Property if (a) the Company approves a sale of the Property prior to a foreclosure sale and such sale is closed; (b) the Company requires an early Claim filing pursuant to Section 5.3, except that such acquisition will be required as a condition to the Insured's filing of a supplemental Claim; or (c) the Property is acquired by someone other than the Insured at a foreclosure sale, as provided in Section 5.11, or thereafter pursuant to exercise of rights of redemption.

5.10 **Sale of a Property by the Insured Before End of Settlement Period**

a. The Insured must submit to the Company any offer to purchase a Property which it receives after the Company has notified the Insured that it will acquire the Property and before the end of the Settlement Period. The Company must then promptly notify the Insured that it will either (1) not approve of such offer, in which case the Company's notice to acquire the Property will remain in effect, or (2) approve such offer, in which case the Company's notice of acquisition will remain in effect, if the approved offer does not close as scheduled. The Insured shall promptly notify the Company if the approved offer does not close as scheduled.

b. If the Company has not notified the Insured that it will acquire the Property, and if the Company's right to acquire the Property has not expired pursuant to Section 6.5 or has not been waived, the Insured must submit to the Company for approval any offer to purchase the Property which would be acceptable to the Insured. The Company shall then promptly either approve or not approve such offer. If the approved offer expires or is terminated, the Company shall be entitled to pay the Loss payable by (1) paying the percentage guaranty option as calculated under Section 6.3(b), or (2) paying the property acquisition settlement option as calculated under Section 6.3(a), and acquiring the Property; but if the Company's right to acquire the Property has expired pursuant to Section 6.5, or been waived, then such acquisition shall be under the same terms and conditions as the expired or terminated offer, except for terms and conditions relating to the sale price and method of payment of the sale price, which shall instead be governed by Section 6.3.

c. The following provisions shall apply to offers submitted to the Company under this Section 5.10:

1. At the time it presents an offer, the Insured must also provide the Company with a good faith estimate of gross proceeds and expenses in sufficient detail for the Company to calculate the estimated net proceeds described below. The Company may not require any changes to the offer or direct the marketing of the Property or expenditures by the Insured for restoration of the Property as a condition to its approval.

2. If the Company approves the offer submitted by the Insured, it must also advise the Insured of the estimated net proceeds which it has calculated. The estimated net proceeds calculated by the Company will be the estimated gross sales proceeds to be received by the Insured less all reasonable

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estimated expenses submitted by the Insured and approved by the Company in its approval of the offer which have been or are expected to be paid by the Insured in obtaining and closing the sale of the Property. If the estimated net proceeds as calculated by the Company is acceptable to the Insured, the Loss payable shall be computed as determined below. If such calculation is not acceptable to the Insured, the offer shall be deemed to have not been approved by the Company.

3. If the Company approves the offer, the Loss payable by the Company under this Section 5.10 will be the lesser of (i) the actual net amount as calculated below, or (ii) the percentage guaranty option under Section 6.3(b) without regard to a sale of the Property. The actual net amount will be the Claim Amount calculated under Section 6.2, except that (a) delinquent interest will be computed through the closing date for sale of the Property and (b) the Claim Amount shall be reduced by the actual net proceeds realized by the Insured from the sale of the Property. The actual net proceeds will be determined in the same manner as the estimated net proceeds, but on the basis of the actual sales proceeds. For purposes of computing a Loss, such actual net proceeds shall not be less than the estimated net proceeds calculated by the Company under this subparagraph (c), or as otherwise approved by the Company.

4. The Company shall not unreasonably withhold its approval of expenses submitted to it after its approval of an offer. Expenses paid to Persons employed or controlled by the Insured or the Owner of the Loan or their internal costs will not be allowed in calculation of either the estimated or actual net proceeds.

5. If requested by the Company, the Insured shall advise the Company of the name of the real estate broker or other Person marketing the Property and authorize such broker or other Person to release marketing information about the Property to the Company, if requested by the Company.

5.11 **Foreclosure Bidding Instructions Given by the Company** — The Insured will be entitled to bid at the foreclosure sale held as part of the Appropriate Proceedings any amount which it determines necessary to obtain Borrower's Title to the Property, unless otherwise directed by the Company. The Company will be entitled to direct the Insured to bid an amount to be determined by the Insured within a minimum and maximum range, as follows:

a. The minimum amount shall not be less than the fair market value of the Property, but if there has been Physical Damage to the Property which affects its fair market value (as determined before such Physical Damage) by more than ten per cent (10%), the fair market value of the Property shall be its fair market value after restoration of the Property.

b. The maximum amount shall not exceed the greater of (1) the fair market value of the Property as determined under subparagraph (a) above, or (2) the estimated Claim Amount less the amount which the Company would pay as the percentage guaranty option under Section 6.3(b).

c. For purposes of this Section 5.11, fair market value shall be determined as of a date acceptable to the Company by an opinion of an independent real estate broker, or by an independent appraiser, in either case selected by or acceptable to the Company.

The Insured is not required to acquire Borrower's Title if it has bid in accordance with this Section 5.11, whether or not pursuant to directions from the Company.

5.12 **Effect of Unexpired Redemption Period on Payment of a Claim** — If the Insured files a Claim prior to expiration of an applicable redemption period, the Loss payable shall only be computed through the date of filing of the Claim, and if the Company elects to acquire the Property, the Insured will remain responsible for management and control of the Property until the Company's acquisition thereof, which may be after expiration of the redemption period, but not later than as required by Section 6.4.

If the Company has paid to the Insured a Claim under its percentage guaranty option in Section 6.3 (b), and the related Property is subsequently redeemed by the Borrower, the Insured shall promptly report such redemption to the Company and reimburse the Company for the amount of the Company's Claim payment, to the extent that

the sum of the Company's Claim payment and the amount realized by the Insured from the redemption exceeds the Claim Amount, as would have been calculated through the date of redemption.

5.13 **Collection Assistance** — If the Company so requests, the Insured shall permit the Company to cooperatively assist the Insured in the collection of moneys due under the Loan, including obtaining information from the Borrower, attempting to develop payment schedules acceptable to the Insured, conducting Property inspections and requesting appraisals of the Property.

6 Loss Payment Procedure

6.1 **Filing of Claim** — The Insured shall file a Claim after, but no later than sixty (60) days following, the conveyance to the Insured of Borrower's Title to the Property. If the Insured is not required to have Borrower's Title to file a Claim for a reason described in Section 5.9, then the Claim must be filed (a) within sixty (60) days after the Property is conveyed in a pre-foreclosure sale, at the foreclosure sale, or by exercise of the rights of redemption or (b) at the time specified by Section 5.3. If the Insured fails to file a Claim within the applicable time, the Insured will not be entitled to, and the Company will not be obligated for, any payment under this Policy for amounts, including additional interest and expenses, which would otherwise be claimable, but which accrue or are incurred after the sixty (60) day period for filing of a Claim.

If the Insured fails to file a Perfected Claim within one hundred eighty (180) days after the filing of the Claim (or within such longer period of time as the Company may allow in writing), the Insured will no longer be entitled to payment of a Loss and the Company will not be obligated to make any payment under this Policy.

6.2 **Calculation of Claim Amount** — Subject to Sections 7.5 and 5.3, the Claim Amount will be an amount equal to the sum of:

a. The amount of unpaid principal balance due under the Loan as of the date of Default without capitalization of delinquent interest, penalties or advances; and

b. The amount of accrued and unpaid interest due on the Loan computed at the contract rate stated in the Loan through the date that the Claim is filed with the Company, but excluding applicable late charges, penalty interest or other changes to the interest rate by reason of Default; and

c. The amount of advances incurred by the Insured under Section 5.7 prior to filing of the Claim (except to Persons employed or controlled by the Insured or the Owner of the Loan or their other internal costs) provided that:

1. Attorney's fees advanced for completion of Appropriate Proceedings and obtaining Possession of the Property will not be allowed to the extent they exceed three percent (3%) of the sum of the unpaid principal balance and the accrued and accumulated interest due; and

2. Such advances, other than attorney's fees, must have first become due and payable after the Default, and payment of such advances must be prorated through the date the Claim is filed with the Company;

less:

(i) The amount of all rents and other payments (excluding proceeds of a sale of the Property and the proceeds of fire and extended coverage insurance) collected or received by the Insured, which are derived from or in any way related to the Property;

(ii) The amount of cash remaining in any escrow account as of the last payment date;

(iii) The amount of cash or other collateral to which the Insured has retained the right of possession as security for the Loan;

(iv) The amount paid under applicable fire and extended coverage policies which are in excess of the cost of restoring and repairing the Property, if the Property is damaged, and which has not been paid to the Borrower or applied to the payment of the Loan as required by the terms of the Loan; and

(v) Any other amounts claimed by the Insured to the extent they are excluded from the Claim Amount by reason of Section 4.

6.3 **Payment of Loss; Company's Options** — Within the Settlement Period, but only if the Insured has satisfied all requirements for a payment of Loss and if the Company has received a Perfected Claim, the Company shall at its sole option exercise its:

a. Property acquisition settlement option. Pay to the Insured as the Loss the Claim Amount calculated in accordance with Section 6.2 for the Company's acquisition of the Property; or

b. Percentage guaranty option. Allow the Insured to retain all rights in and title to the Property, and pay to the Insured as the Loss the Claim Amount calculated in accordance with Section 6.2 of this Policy multiplied by the percentage of coverage or as otherwise calculated as specified in the Certificate. However, if prior to the Company's payment of the Loss, a third party acquires title to the Property at the foreclosure sale or a Borrower redeems the Property (unless such acquisition or redemption occurs because the Insured failed to bid as provided in Section 5.11), then the Company shall pay the lesser of: (i) the percentage guaranty option amount described above; or (ii) the difference between the Claim Amount and the amount realized by the Insured at the foreclosure sale or redemption; or

c. Pre-Claim sale option. Pay to the Insured as the Loss the amount calculated in accordance with Section 5.10, if the terms and conditions of Section 5.10 are met.

In addition to the sum due pursuant to the option described above which the Company selects, the Loss payable by the Company will include the other amounts provided for under Sections 6.5 or 7.2 when such Sections are applicable. The Company will deduct from its payment of Loss such amounts as may be permitted by this Policy and the aggregate amounts of any payments of Loss which it had previously made. In the event of a Loss on a Loan with renewal premiums due monthly, which results from a Default covered under Section 2.6(a), the Company shall deduct from the payment of Loss an amount equal to any unpaid renewal premiums for the subject Loan through the end of the monthly renewal period in which such Default occurred.

6.4 **Calculation of Settlement Period** — The Settlement Period will be a sixty (60) day period after the Company's receipt of a Claim, calculated as follows:

a. No later than the twentieth (20th) day after filing of a Claim, the Company may notify the Insured of additional documents or information which it requires for processing the Claim. The sixty-day period will be suspended until the Company receives such additional documents and information. The Company may request additional documents and information after such twenty-day period, and the Insured must use reasonable efforts to satisfy such request.

b. No later than the sixtieth (60th) day after filing of a Claim, the Company may notify the Insured that it will require access to the Property sufficient to inspect, appraise and evaluate the Property. If the Company does not notify the Insured by that date, its right to such access will be deemed waived. If such notice is ~~given, the Insured will use its best efforts to provide~~ access to the Company and, if access is not then available, the sixty day period will be suspended from the date such notice was given until the Company receives notice from the Insured that access is available to it. If access is in fact not available when sought by the Company after such notice from the Insured, the Company will promptly notify the Insured of such unavailability, and the passage of the sixty day period will remain suspended as if the Insured's notice of availability had not been given to the Company.

c. If the Company has elected to acquire the Property in settlement of a Claim, the sixty day period also will be suspended if necessary for there to be a period of ten (10) days after the date on which the Insured satisfies all conditions to acquisition, including any required restoration of the Property, for the Insured's

delivery of a recordable deed and title policy or opinion evidencing Good and Merchantable Title (not subject to any rights of redemption, unless the Company waives such requirement) and, if applicable, delivery of Possession to the Property.

d. If the sixty day period is suspended for more than one reason, the resulting suspended periods will only be cumulative if in fact they occur at different times; to the extent they occur simultaneously, they will not be cumulative.

6.5 **Payment by the Company After the Settlement Period** — If the Company has not paid a Loss during the Settlement Period, then (a) the Company will include in its payment of Loss, if a Loss is ultimately payable, simple interest on the amount payable accruing after the Settlement Period to the date of payment of Loss at the applicable interest rate or rates which would have been payable on the Loan during such period, and (b) the Company will no longer be entitled to acquire the Property as an option for payment of the Loss.

The Company must either pay the amount of applicable Loss (including any additional applicable interest as computed above) or deny the Claim in its entirety within (a) one hundred twenty (120) days after expiration of the Settlement Period, or (b) if the Settlement Period has not expired, no later than one hundred eighty (180) days after filing of the Claim. If at a later date it is finally determined by agreement between the Insured and the Company (or by completion of legal or other proceedings to which the Insured and the Company are parties) that the Company was not entitled to deny all or a portion of the Claim, the Company will include in any resulting subsequent payment of Loss interest as calculated above through the date of such payment on the amount of Loss which the Company was not entitled to deny.

6.6 **Discharge of Obligation** — Payment by the Company of the amount of Loss required to be paid in accordance with this Policy will be a full and final discharge of its obligation with respect to such Loss under this Policy.

7 **Additional Conditions**

7.1 **Proceedings of Eminent Domain** — In the event that part or all of a Property is taken by eminent domain, or condemnation or by any other proceedings by federal, state or local governmental unit or agency, the Insured must require that the Borrower apply the maximum permissible amount of any compensation awarded in such proceedings to reduce the principal balance of the Loan, in accordance with the law of the jurisdiction where the Property is located.

7.2 **Pursuit of Deficiencies**

a. The Insured will be entitled to pursue Appropriate Proceedings, or shall at the direction of the Company pursue Appropriate Proceedings through the end of the Settlement Period, which may result in the Borrower becoming liable for a deficiency after completion of the Insured's acquisition of a Property. Such pursuit may not be directed by the Company unless such deficiency is estimated to exceed $7,500. If the Company proposes to pursue a deficiency judgment, in whole or in part for its account, it will notify the Insured at least thirty (30) days before the foreclosure sale. If the Company does not so notify the Insured, the deficiency judgment, if established by the Insured, will be solely for the account of the Insured, and the Company will not be subrogated to any rights to pursue the deficiency judgment.

b. The following provisions will apply if, in completing Appropriate Proceedings there are additional expenses ~~advanced pursuant to Section 5.7 or additional interest accrued on the Loan, due to (1) an additional~~ redemptive period or a delay in acquisition of Borrower's Title, which period or delay is directly related to establishing the deficiency judgment or (2) legal proceedings which are necessary to establish and pursue the deficiency judgment and which would not otherwise be the custom and practice used.

i. If the deficiency judgment is to be established, in whole or in part, for the account of the Company, the Company must pay the Insured at the time of payment of the Claim, regardless of which settlement option the Company has selected, the full amount of:

(A) such additional expenses advanced pursuant to Section 5.7 by the Insured; and

(B) such additional interest accrued on the unpaid principal balance of the Loan at the contract rate stated in the Loan, but excluding applicable late charges, penalty interest, or other changes to the interest rate by reason of Default.

ii. If the deficiency judgment is not to be established, in whole or in part, for the account of the Company, none of the additional interest or expenses of the type described in subparagraph (i) above will be includable in the Claim Amount or payable at any time by the Company.

iii. For purposes of determining the additional expenses described in subparagraph (i) above resulting from pursuing the deficiency judgment, the limitation on attorneys' fees in Section 6.2 will not apply.

iv. All of the additional interest, expenses, attorney's fees and court expenses described in subparagraph (i) above will be accrued or advanced only through acquisition of Borrower's Title, including any additional redemptive period.

c. The Company and the Insured may agree generally or with respect to a Loan to different terms and conditions than set forth in this Section 7.2. The Company and the Insured also may agree to the joint pursuit or other arrangements for the collection of deficiency judgments on mutually acceptable terms and conditions.

7.3 **Subrogation** — Subject to Section 7.2(a), and only to the extent that the Company is entitled under applicable law to pursue such deficiency rights, the Company will be subrogated, upon payment of the Loss, in the amount thereof and with an equal priority to all of the Insured's rights of recovery against a Borrower and any other Person relating to the Loan or to the Property. The Insured must execute and deliver at the request of the Company such instruments and papers and undertake such actions as may be necessary to transfer, assign and secure such rights. The Insured shall refrain from any action, either before or after payment of a Loss, that prejudices such rights.

7.4 **Policy for Exclusive Benefit of the Insured and the Owner** — A Commitment and Certificate issued as the result of any Application submitted hereunder and the coverage provided under this Policy will be for the sole and exclusive benefit of the Insured and the Owner of the related Loan, and in no event will any Borrower or other Person be deemed a party to, or an intended beneficiary of, this Policy or any Commitment or Certificate.

7.5 **Effect of Borrower Insolvency or Bankruptcy on Principal Balance** — If under applicable insolvency or bankruptcy law, a Loan's principal balance secured by a Property is reduced (after all appeals of such reduction are final or the time for such appeals has lapsed without appeal), the portion of such principal balance of the Loan not secured by the Property, and related interest, will be includable in the Claim Amount, as provided in this Section 7.5.

If a Default occurs on the Loan, the Insured has acquired Borrower's Title or Good and Merchantable Title to the Property as required by this Policy, and all other requirements for filing of a Claim are complied with, the Insured will be entitled to include in the Claim Amount (a) the amount of the principal balance of the Loan which was deemed unsecured under applicable insolvency or bankruptcy law, less any collections or payments on such unsecured principal balance received by the Insured, and (b) interest thereon at the rate and as computed in Section 6.2, from the date of Default giving rise to the Claim (but for no prior period). In no event will any expenses or other amounts associated with the amount by which the principal balance of the Loan became unsecured be includable in the Claim Amount, directly or by an addition to the principal balance includable in the Claim Amount.

7.6 **Arbitration of Disputes; Suits and Actions Brought by the Insured**

a. Unless prohibited by applicable law, all controversies, disputes or other assertions of liability or rights arising out of or relating to this Policy, including the breach, interpretation or construction thereof, shall be settled by arbitration. Notwithstanding the foregoing, the Company or the Insured both retain the right to seek a declaratory judgement from a court of competent jurisdiction on matters of interpretation of the Policy. Such arbitration shall be conducted in accordance with the Title Insurance Arbitration Rules of the American Arbitration Association in effect on the date the demand for arbitration is made, or if such Rules are not then in effect, such other Rules of the American Arbitration Association as the Company may designate as its replacement.

The arbitrator(s) shall be neutral person(s) selected from the American Arbitration Association's National Panel of Arbitrators familiar with the mortgage lending or mortgage guaranty insurance business. Any proposed arbitrator may be disqualified during the selection process, at the option of either party, if they are, or during the previous two (2) years have been, an employee, officer or director of any mortgage guaranty insurer, or of any entity engaged in the origination, purchase, sale or servicing of mortgage loans or mortgage-backed securities.

b. No suit or action (including arbitration hereunder) brought by the Insured against the Company with respect to the Company's liability for a Claim under this Policy shall be sustained in any court of law or equity or by arbitration unless the Insured has substantially complied with the terms and conditions of this Policy, and unless the suit or action is commenced within three (3) years (five (5) years in Florida or Kansas) after the Insured has acquired Borrower's Title to the Property or sale of the Property approved by the Company is completed, whichever is applicable to a Loan. No such suit or action with respect to a Claim may be brought by the Insured against the Company until sixty (60) days after such acquisition of Borrower's Title or sale, as applicable to a Loan.

c. If a dispute arises concerning the Loan which involves either the Property or the Insured, the Company has the right to protect its interest by defending the suit, even if the allegations contained in such suit are groundless, false or fraudulent. The Company is not required to defend any lawsuit involving the Insured, the Property or the Loan.

7.7 **Release of Borrower; Defenses of Borrower** — The Insured's execution of a release or waiver of the right to collect any portion of the unpaid principal balance of a Loan or other amounts due under the Loan will release the Company from its obligation under its Certificate to the extent and amount of said release. If, under applicable law, the Borrower successfully asserts defenses which have the effect of releasing, in whole or in part, the Borrower's obligation to repay the Loan, or if for any other reason the Borrower is released from such obligation, the Company will be released to the same extent and amount from its liability under this Policy, except as provided by Section 7.5.

7.8 **Amendments; No Waiver; Rights and Remedies; Use of Term "Including"**

a. The Company reserves the right to amend the terms and conditions of this Policy from time to time; provided, however, that any such amendment will be effective only after the Company has given the Insured written notice thereof by endorsement setting forth the amendment. Such amendment will only be applicable to those Certificates where the related Commitment was issued on or after the effective date of the amendment.

b. No condition or requirement of this Policy will be deemed waived, modified or otherwise compromised unless that waiver, modification or compromise is stated in a writing properly executed on behalf of the Company. Each of the conditions and requirements of this Policy is severable, and a waiver, modification or compromise of one will not be construed as a waiver, modification or compromise of any other.

c. No right or remedy of the Company provided for by this Policy will be exclusive of, or limit, any other rights or remedies set forth in this Policy or otherwise available to the Company at law or equity.

d. As used in this Policy, the term "include" or "including" will mean "include or including, without limitation."

7.9 No Agency — Neither the Insured, any Servicer or Owner, nor any of their employees or agents, will be deemed for any reason to be agents of the Company. Neither the Company, nor any of its employees or agents, will be deemed for any reason to be agents of any Insured, Servicer or Owner.

7.10 Successors and Assigns — This Policy will inure to the benefit of and shall be binding upon the Company and the Insured and their respective successors and permitted assigns.

7.11 **Applicable Law and Conformity to Law** — All matters under this Policy will be governed by and construed in accordance with the laws of the jurisdiction in which the office of the original Insured on a Certificate is located. Any provision of this Policy which is in conflict with any provision of the law of such jurisdiction is hereby amended to conform to the provisions required by that law.

7.12 **Notice** — All claims, premium payments, tenders, reports, other data and any other notices required to be submitted to the Company by the Insured must be sent to the Company at MGIC Plaza, 250 East Kilbourn Avenue, Milwaukee, WI 53202. The Company may change this address by giving written notice to the Insured. Unless the Insured otherwise notifies the Company in writing, all notices to the Insured must be sent to the address on the face of this Policy or, if the Insured is not located at such address, to the last known address of the Insured.

All notices under this Policy, whether or not identified in this Policy as required to be in writing, will be effective only if in writing and only upon receipt thereof. Written notices may instead be given in the form of telecopy or, if acceptable to the Company (for notices given to the Company) or to the Insured (for notices given to the Insured) in the form of computer tape or computer-generated or any other electronic message. A telecopy or such tape or message shall be effective only when received. The Company and the Insured may mutually agree that notices will be sent to any additional Person. Except as expressly agreed to by the Company and the Insured, no liability shall be incurred by the Company for the failure to give a notice to a Person other than the Insured.

7.13 **Reports and Examinations** — The Company may request, and the Insured must provide, such files, reports or information as the Company may deem necessary pertaining to any Loan, and the Company will be entitled to inspect the files, books and records of the Insured or any of its representatives pertaining to such Loan.

7.14 **Electronic Media** — The Company and the Insured may, from time to time, deliver or transfer information, documents or other data between them by electronic media acceptable to them. In addition, the Company and the Insured may maintain information, documents or other data on electronic media or other media generally accepted for business records, including microfiche. Such electronic or other media will be as equally acceptable for all purposes between the Insured and the Company as information, documents or other data maintained in printed or written form.

COMMERCIAL UNION AUSTRALIA
MORTGAGE INSURANCE
CORPORATION LIMITED
A.C.N. 000 781 171

Residential Mortgage Insurance

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37 YORK STREET SYDNEY
GPO BOX 3969 SYDNEY NSW 2001
DX 10188 SYDNEY STOCK EXCHANGE
TELEPHONE (02) 248 6888
FACSIMILE (02) 267 1494

TERMS AND CONDITIONS

1. TERMINATION OF INSURANCE

The liability of the Corporation under this Policy shall cease and the Corporation shall not be liable to pay any claim hereunder in any of the following circumstances:

(a) After the expiry date, provided that where Notice of Default is given to the Corporation pursuant to Condition 11 hereof the insurance shall continue for the purpose of a claim made by the Mortgagee in respect of the default specified in the Notice;

(b) Prior to the expiry date upon payment by the Corporation of any claim by the Mortgagee for loss in accordance with the provisions hereof, provided this paragraph shall not apply to a claim only for interest where the Policy provides indemnity for prompt payment of interest;

(c) If at any time the Mortgagee's rights to recover the loan or to enforce the Mortgage cease or are postponed otherwise than by the exercise by the Mortgagee of his rights under the Mortgage;

(d) If at any time any guarantee or indemnity given to the Mortgagee in respect of the loan ceases to be enforceable otherwise than by the exercise by the Mortgagee of his rights;

(e) If at any time there is any mortgage, charge or other security (other than a statutory charge in respect of rates and land tax) over the Mortgaged Premises having priority over the Mortgage hereby insured of which the Corporation had no written notice at the proposal date;

(f) If there has been any material misstatement, omission or misrepresentation in the statements and/or answers made in obtaining this Policy, whether in the proposal including any annexure thereto, open policy insurance advice including any annexure thereto, application, request or any other document or information supplied to the Corporation or otherwise;

(g) If the Mortgage is or becomes invalid or unenforceable or loses its priority or if it is not registered as a legal mortgage promptly after the loan is made;

(h) If the Mortgage is not a first mortgage and the Mortgagee refuses or fails to take such action as the Corporation may require to oppose any application by a prior Mortgagee for foreclosure against the Borrower and the Mortgagee;

(i) If the Mortgagee, without the approval of the Corporation, approves any transfer or assignment of the Mortgaged Premises without full discharge of the Mortgage and all moneys secured thereby;

(j) If the Mortgagee fails to pay any premium in respect of the insurance of the loan within thirty (30) days from the time or times stipulated by the Corporation from time to time for the payment thereof.

2. ASSESSMENT OF CLAIMS

The amount of the Mortgagee's loss shall, at the option of the Corporation, be reduced by such sum or sums as in the opinion of the Corporation represent an amount by which the value of the rights of the Mortgagee in relation to the loan or the Mortgaged Premises has been diminished or impaired by reason of any negligence of the Mortgagee or any Mortgage Manager in the administration of the loan or in the protection of the Mortgaged Premises or by reason of the Mortgagee's failure to comply with any condition of this Policy (not already stated to be a matter which would result in the Termination of Insurance as set out in Condition 1 hereof) or failure to comply with any direction given by the Corporation under this Policy The determination of the Corporation of the value of such diminution or impairment under this condition shall be conclusive.

3. MORTGAGE MANAGER

The Mortgagee, or the Corporation if it so requires, may appoint a Mortgage Manager who shall be such person or Company as the Corporation shall from time to time require or as the Corporation shall from time to time approve and the Mortgage Manager shall be changed from time to time at the Corporation's request and the Mortgage Manager shall on behalf of the Mortgagee attend to the following actions without limiting the generality thereof:

(a) Administer and manage the insured loan and the receipt of the principal, interest and other moneys payable under the Mortgage.

(b) Supervise the observance and performance by the Borrower of the covenants, provisions and conditions of the Mortgage.

(c) Report defaults to the Corporation and take appropriate action for recovery as required by conditions of this Policy.

4. BUILDINGS TO BE ERECTED OR PROPOSED SUBDIVISIONS

If the Mortgaged Premises include buildings to be erected or building works in the course of construction or land and/or buildings in the course of subdivision:

(a) All construction of the building works or the subdivision shall be in accordance with the plans and specifications approved by the relevant local government or other competent authorities.

(b) The Mortgagee shall retain an adequate proportion of the principal sum sufficient to ensure that the construction of building works or the subdivision is completed.

(c) The Corporation may require the Mortgagee to complete the construction of the building works or the subdivision in accordance with the plans and specifications approved by the relevant local government or other competent authorities before any claim for loss may be made against the Corporation under the Policy, in which case any amounts expended by the Mortgagee in excess of the principal sum secured by the Mortgage shall not be included in the claim for loss and shall not be recoverable against the Corporation.

5. GENERAL INSURANCE POLICY

(a) The Mortgagee will include in the Mortgage to be insured, a covenant by the Borrower that the Borrower will properly and adequately insure and keep insured, under a General Insurance Policy in the joint names of the Borrower and the Mortgagee, the premises against damage by fire and other usual hazards under a normal householders or house owners policy (in this Policy it is called a General Insurance Policy) with a reputable insurer and that in the event of default by the Borrower in so doing the Mortgagee shall insure the Mortgaged Property under a General Insurance Policy at the cost and expense of the Borrower.

(b) The Mortgagee will not advance any part of the loan to the Borrower unless and until the Mortgaged Premises are insured against the risks stated in Condition 5(a) hereof for a period of not less than twelve (12) months from the date such insurance became effective.

(c) If at any time the Mortgaged Premises are not insured under a General Insurance Policy and the Mortgagee becomes aware of the fact, the Mortgagee shall within ten (10) days after becoming so aware, effect or cause to be effected a General Insurance Policy in respect of the Mortgaged Premises

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(d) Upon the request of the Corporation, the Mortgagee will make enquiries to ascertain if the Mortgaged Premises are insured under a General Insurance Policy, and if it is ascertained that the Mortgaged Premises are not so insured, the Mortgagee shall, within ten (10) days thereafter, effect or cause to be effected, a General Insurance Policy in respect of the Mortgaged Premises, provided however, that the Mortgagee will be relieved of his obligation under this clause and the preceding paragraph (c) if, after reasonable enquiry, the Mortgagee is unable to effect or cause to be effected such a Policy by reason of the condition or state of repair of the improvements included in the Mortgaged Premises and so informs the Corporation in writing within a period of ten (10) days after becoming aware of his inability to effect such insurance.

6. APPLICATION OF COMPENSATION PAYMENTS, ETC.

Compensation payable in respect of any resumption or compulsory acquisition of the Mortgaged Premises or any part thereof and any sums paid or payable under a General Insurance Policy in relation to loss arising from destruction or damage to the Mortgaged Property, if not applied in restoration or repair, will be applied by the Mortgagee in reduction of the principal moneys secured by the Mortgage unless otherwise agreed in writing between the Corporation and the Mortgagee.

7. NOTICE OF DAMAGE

If the Mortgagee becomes aware of any loss or physical damage to the Mortgaged Premises, the Mortgagee shall notify the Corporation, in writing, within fourteen (14) days after becoming so aware.

8. RESTORATION OF DAMAGE

If the Mortgaged Premises shall be damaged or totally or partially destroyed by any cause other than damage caused by fire; explosion other than nuclear explosion; lightning; thunderbolt; storm and tempest; floods; tidal wave; subsidence; earthquake; erosion; earth movement; riots; strikes; civic commotion; malicious damage; impact caused by aircraft; road vehicles; animals or falling trees, the Mortgagee shall if so required to do by the Corporation cause the Mortgaged Premises to be restored to their condition immediately prior to such damage or destruction (reasonable wear and tear excepted) before any claim for loss may be made against the Corporation under its Policy. Any moneys expended by the Mortgagee in such restoration shall not be included in the claim for loss.

9. ADDITIONAL LOANS

The Mortgagee shall not make an additional loan to the Mortgagor without the prior written consent of the Corporation.

10. VARIATION OF LOAN CONDITIONS AND/OR MORTGAGE AND/OR LOAN DOCUMENTS

The Mortgagee shall not without the prior written consent of the Corporation:

(a) ~~Advance any further money secured by the Mortgage otherwise than by payment~~ of moneys for the protection of the Mortgaged Premises as provided by the Mortgage.

(b) Compromise, postpone or partially discharge the Mortgage or otherwise derogate the Mortgagee's rights against the Mortgagor or the Mortgaged Premises in respect of the loan.

~~(c) Alter the terms of repayment of the loan or increase the~~ rate of interest charged thereon or grant any time or other indulgence or vary any right of the Mortgagor or any Guarantor.

(d) Vary the terms or provisions of the Mortgage.

(e) Consent to the variation of the terms or provisions of any prior mortgage or other security having priority to the Mortgage insured by this Policy.

(f) Capitalize any interest notwithstanding any provision in the Mortgage to that effect.

11. NOTICE OF DEFAULT AND ARREARS REPORT

(a) When repayment instalments (whether of principal or interest or both) are payable monthly or more frequently, should the Mortgagor be in default or remain in arrears for a period of or exceeding four (4) calendar months in the case of a first Mortgage and two (2) calendar months in the case of a second Mortgage, in the payment of principal or interest or any instalment thereof or any part of an instalment then the Mortgagee shall notify the Corporation of the default within thirty (30) days of such period of default and shall report monthly thereafter until such default is remedied or a claim for loss is submitted pursuant to the provisions hereof.

(b) Where repayment instalments (whether of principal or interest or both) are payable less frequently than monthly, should the Mortgagor be in default or remain in arrears for a period of or exceeding one (1) calendar month in the case of either a first or subsequent Mortgage, in the payment of principal or interest or any instalments thereof, then the Mortgagee shall notify the Corporation of such default within thirty (30) days of such period of default and shall report monthly thereafter until such default is remedied or a claim for loss is submitted pursuant to the provisions hereof.

(c) If any principal or interest has not been fully repaid by the Mortgagor to the Mortgagee on the expiry date of this Policy as stated in the Schedule hereto in accordance with any covenant so to do in the Mortgage, the Mortgagee shall notify the Corporation within fourteen (14) days thereafter of such default and shall report monthly thereafter until such default is remedied or a claim for loss is submitted pursuant to the provisions hereof.

(d) Should the Mortgagor or any Guarantor be declared bankrupt or be wound up or make a scheme of arrangement with his creditors under the Bankruptcy Act or default in the observance of any covenant, provision or condition of the Mortgage, other than those relating to the payment of principal or interest, notice thereof shall be given to the Corporation within fourteen (14) days of such fact or default coming to the knowledge of the Mortgagee and the Mortgagee shall keep the Corporation fully informed of all information received by the Mortgagee in relation thereto and shall furnish such information thereon as the Corporation requests.

(e) Should the Mortgage be a second mortgage and the Mortgagee becomes aware that the Mortgagor is in default in the observance or performance of any of the covenants, provisions or conditions of the first mortgage, or that the first mortgagee has exercised or proposes to exercise any of his rights, powers or remedies thereunder, or the principal sum owing under the first mortgage has increased since the date of the proposal or open policy advice the Mortgagee shall notify the Corporation thereof within seven (7) days of becoming so aware, and shall keep the Corporation fully informed of all information received by ~~the Mortgagee in relation thereto and shall furnish such further information~~ thereon as the Corporation requests.

(f) If any amount, not being principal or interest or any instalment thereof, is debited to the Mortgage loan account and is not reimbursed within a period of one (1) calendar month, the Mortgagee shall notify the Corporation of the details of the amount so debited within thirty (30) days of such monthly period and shall report monthly thereafter until such unpaid amount is reimbursed to the Mortgage loan account.

(g) The notification and report to the Corporation referred to in (a), (b), (c), (d) and (f) above shall include the balance of the Mortgage loan account owing, the amount of the payments of other items either in default or debited to the Mortgage loan account and not reimbursed, the period of such default and the action being taken by the Mortgagee.

12. PROCEDURE ON DEFAULT AND EXERCISE OF REMEDIES

(a) If the Mortgagor defaults for a period of sixty (60) days in the payment of either principal or interest or any instalment thereof the Mortgagee shall at the request of the Corporation take all such action as shall be permitted by law to cause all rents, profits and other moneys, payable to the Mortgagor by reason of his interest in the Mortgaged Premises, to be paid directly to the Mortgagee or the Mortgagee's receiver, nominee or agent and all such moneys so received shall be applied in payment firstly of the interest in arrears (at the lowest rate), secondly in payment of the principal in arrears, and thirdly, in payment of any General Insurance premium, legal fees, rates and taxes debited to the Mortgage loan account but unpaid by the Mortgagor.

(b) If the Mortgagor defaults for a period of ninety (90) or more consecutive days in payment of either principal or interest or any instalment thereof the Corporation shall do one of the following:

(i) pay the Mortgagee the amount of any instalment or instalments of principal and interest (or either) in arrears on such terms as to reimbursement or otherwise as the Corporation may determine; or

(ii) pay to the Mortgagee the amount owing as calculated in accordance with Condition 14 subject to and provided that the Mortgagee shall simultaneously with such payment transfer to the Corporation at the Corporation's expense, the Mortgage and all collateral securities and guarantees given in respect of the loan and all the Mortgagee's rights thereunder, in every case in such form and manner as the Corporation may require and provided also that the Mortgagee shall give the Corporation a Power of Attorney in such form as it may require, for the purpose of obtaining from the Mortgagor all moneys secured by the Mortgage and for enforcing the Mortgage and all collateral securities and guarantees given with respect to the loan; or

(iii) require the Mortgagee to take such action under the Mortgage and under any collateral security or guarantee given in respect to the loan as the Corporation may direct and the Mortgagee shall institute such action within thirty (30) days thereafter and shall diligently carry it through to completion and upon such completion the Mortgagee is entitled to be paid an amount owing as calculated in accordance with Condition 14.

(c) If the Mortgagor defaults in the payment of any sums owing to the Mortgagee pursuant to the Mortgage which in aggregate, equal or exceed the sum of repayment instalments payable in a period of four (4) calendar months or if the Mortgage loan remains unpaid for twenty-one (21) days after the expiration date of the Policy the Mortgagee shall, unless the Corporation instructs otherwise, take the necessary steps to obtain vacant possession of the Mortgaged Property and shall inform the Corporation within ten (10) days of obtaining vacant possession of the Mortgaged Property.

(d) Upon obtaining vacant possession the Mortgagee shall proceed forthwith to sell the Mortgaged Premises in the manner as nominated by the Corporation PROVIDED THAT the Corporation shall issue an indemnity to the Mortgagee, if the Corporation's nominated method of sale is other than by public auction and PROVIDED THAT the Corporation has not instructed or advised the Mortgagee to take, or to adopt, another course of action.

(e) Should the Mortgagee exercise or be requested by the Corporation to exercise his power of sale, the Mortgagee shall inform the Corporation of the current market value of the security, the total amount then owing thereunder, the amount of the principal and interest in arrears and the extent to which the loan is in default together with information as to the amount of any statutory charges for unpaid rates and land tax and the Mortgagee shall give the Corporation at least fourteen (14) days notice of any intended sale of the Mortgaged Premises and will inform the Corporation of all reasonable offers to purchase the same and, if the proposed sale is by auction, then the Corporation shall be advised of the proposed reserve and the Mortgagee agrees that the Mortgaged Premises shall not be sold without the Corporation's consent.

(f) The Mortgagee shall provide the Corporation with copies of all contracts and legal process relating to any action ~~taken by him and shall report to the~~ Corporation at monthly intervals on the progress and position of the action taken by the Mortgagee to recover the moneys owing and realise the security.

13. SUBMISSION OF CLAIM FOR LOSS

Where the Mortgagee has exercised power of sale over the Mortgaged Premises or has completed foreclosure action or any action required by the Corporation or called upon the Guarantor, the Mortgagee shall submit a claim for loss to the Corporation within thirty (30) days or such longer period as the Corporation may approve in writing from the date of the completion of the sale or from the date on which the Mortgaged Premises became vested in the Mortgagee by foreclosure or any action required by the Corporation or call made under the guarantee and such claim shall be in a form acceptable to the Corporation and shall be verified by such evidence as the Corporation shall require.

14. CALCULATION OF LOSS OR AMOUNT OWING

In determining the amounts to be included in the calculation of the loss as provided for, all moneys received by the Mortgagee or applied by the Mortgagee in satisfaction in part or whole of the Mortgagor's covenants under the Mortgage from the date of advance of the principal sum or the first progress payment thereof shall be applied in the following order in satisfaction of:

(i) firstly, interest payable upon the principal sum, and any balance then remaining shall be applied next;

(ii) in reduction of the principal sum, and any balance then remaining shall be applied next;

(iii) in satisfaction or reimbursement of moneys paid by the Mortgagee in respect of those outgoings provided for in sub-conditions (c) to (g) of this condition, and only then may any balance then remaining be applied;

(iv) in payment of any fines, penalties, penalty interest or other charges or levies which pursuant to the Mortgage the Mortgagor is obliged to pay to the Mortgagee.

For the purpose of this Policy, the amount owing for the purpose of Condition 12(b)(ii) and the amount of the Mortgagee's loss shall be calculated as follows:

A. The total of the following shall be ascertained:

(a) The unpaid principal of the loan.

(b) Interest unpaid to the earliest of:

(i) sixty (60) days or such longer period as the Corporation may agree to in writing after the date of the contract for sale under which the Mortgagee has sold the Mortgaged Premises or the date of the completion of the compulsory acquisition of the Mortgaged Premises;

(ii) the date upon which the Mortgagee has become the absolute owner of the Mortgaged Premises by foreclosure;

(iii) the date upon which a claim is paid by the Corporation under this Policy;

(iv) the date of the Corporation's election under 12(b)(ii) where the Corporation makes such an election;

(v) the date of the settlement of the Contract for Sale;

(vi) where the Mortgage is not a first mortgage and where a prior mortgagee has sold the Mortgaged Premises or has taken foreclosure action, the date on which the Mortgagee receives from the prior mortgagee so much of the proceeds of the sale as is so payable, or the date on which the Mortgagee becomes aware of the completion of the sale or that the prior mortgagee has become absolute owner of the Mortgaged Premises following foreclosure.

(c) Amounts paid by the Mortgagee for General Insurance premiums, rates, taxes and other statutory charges properly and necessarily paid for the preservation of the Mortgaged Premises PROVIDED THAT the amount to be allowed for land tax under this paragraph will be limited to that proportion of total land tax payable by the Mortgagor which the taxable value of the Mortgaged Premises bears to the taxable value of all taxable land owned by the Mortgagor at the date of calculation of land tax liability.

(d) Other amounts reasonably and necessarily expended by the Mortgagee in maintaining and preserving the Mortgaged Premises not exceeding in ~~all five hundred dollars ($500)~~ or in excess thereof only with the prior written consent of the Corporation.

(e) Reasonable legal fees and disbursements incidental thereto properly and necessarily incurred by the Mortgagee in enforcing or protecting the Mortgagee's rights under the Mortgage or collateral security or any guarantee given to the Mortgagee in connection with the Mortgage.

(f) Any licensed real estate agent's commission and auction expenses, properly incurred, related to the sale of the Mortgaged Premises by the Mortgagee.

(g) Any amount paid to discharge a prior mortgage, of which the Corporation had notice at the date of the proposal

Where the Mortgage provides for the payment of interest at two or more rates the amount to be allowed in the claim for interest unpaid shall be calculated at the lowest rate and no higher than the interest rate stated in the proposal unless otherwise agreed in writing by the Corporation. In no case shall there be included in any "Calculation of Loss" or "Amount Owing" pursuant to this condition, any fines or penalties, additional interest and other sums of a like nature or interest payable as a result of the capitalisation of any other item debited to the Mortgage loan account, which does not comprise an item which is specified in paragraphs (c) to (g) inclusive of this Condition.

B. The total of the following shall be ascertained:

(a) The sale price of the Mortgaged Premises, or, if the Mortgaged Premises be foreclosed, the market value thereof as determined by the Corporation at the time of the decree or order absolute for foreclosure.

(b) All moneys received by the Mortgagee for rents and profits and for compensation for resumption, compulsory acquisition and the like in respect of the Mortgaged Premises or any part thereof or under any General Insurance Policy which has not already been applied in accordance with any prior clause of this Policy.

(c) All moneys received from any collateral security and from any surety or guarantor of the loan or refund of premium on the cancellation of a General Insurance Policy relative to the Mortgaged Premises.

(d) All sums which the Corporation is entitled to deduct pursuant to Condition 2 hereof.

The amount by which the total of the items in paragraph A exceeds the total of those in paragraph B shall for the purpose of this insurance Policy be the amount owing or the Mortgagee's loss as the case shall require.

C. Except where the claim is settled pursuant to the Corporation's election under Condition 12(b)(i) or (ii) the amount payable under this Policy shall be the lesser of:

(i) The Mortgagee's loss calculated in accordance with paragraphs A and B of this Condition; and

(ii) That proportion of the principal of the loan amount that shall be owing at the time when the default occurs which brings about the claim under the Policy, that the Sum Insured stated in the Schedule or the Special Conditions to the Policy bears to the Original Loan Amount stated in the Schedule or the Special Conditions.

15. PAYMENT OF CLAIM FOR LOSS AND TRANSFER/ ASSIGNMENT OF THE MORTGAGEE'S INTEREST

(a) Payment in settlement of a claim for loss will, so far as is practicable, be made to the Mortgagee within seven (7) days of the Corporation's receipt of the completed claim for loss hereunder.

(b) Where the Mortgagee has exercised power of sale as a condition precedent to payment of the Mortgagee's loss the Mortgagee shall, at the Corporation's request and at its expense, transfer or assign all the rights of the Mortgagee in and to any collateral security or guarantee given in connection with the loan.

(c) The Corporation may at its discretion agree to pay a claim hereunder notwithstanding that the Mortgagee may not have exercised any of the rights under a security, collateral security or guarantee given in connection with the loan PROVIDED THAT the Corporation may as a condition of payment require an assignment or transfer to it by the Mortgagee of such security, collateral security or guarantee and the rights thereunder.

16. APPLICATION OF MONEYS RECEIVED AFTER DATE CLAIM SUBMITTED

All sums received by the Mortgagee on account of the loan after the date on which a claim is made hereunder shall be held in trust for the Corporation and shall forthwith be paid by the Mortgagee to the Corporation.

17. ASSIGNMENT OF MORTGAGE

If the Mortgage is assigned or transferred by the Mortgagee (otherwise than by operation of law) this insurance may, with the prior written consent of the Corporation but not otherwise, be assigned to the assignee or transferee PROVIDED THAT the Corporation may require the Mortgage to be or continue to be administered and managed by a Mortgage Manager approved by the Corporation

18. WHEN REQUESTED THE MORTGAGEE SHALL PROVIDE TO THE CORPORATION A COPY OF THE MORTGAGE

19. NOTICES

Any notice to be given hereunder shall be deemed to be duly given if the same be in writing and be left at or sent through the post in a prepaid envelope addressed to:

(a) The Corporation at the address shown on this Policy or the State Office from which this Policy has been issued; or

(b) The Mortgagee at the address shown in the Schedule hereto or such other address as the Mortgagee may from time to time specify by notice in writing to the Corporation. Every such notice sent by post as aforesaid shall be deemed to have been received at the time when the envelope containing such notice would in the ordinary course of post have been delivered.

20. APPLICATION OF STATE LAW

Any provision or condition of this Policy which is in conflict with any law of the Commonwealth of Australia or of any of the States or Territories in which the Policy is effective shall be deemed to have been amended to conform with the minimum requirements of such law.

21. TO WHOM PROVISIONS APPLICABLE

The provisions of this Policy shall enure for the benefit of and be binding upon the Corporation and the Mortgagee and their respective successors and assigns.

22. WAIVER

No condition or requirement of this Policy and no right of the Corporation shall be deemed waived unless it is expressly stated in writing to be waived by the Corporation.

23. SUIT

No right of action on this Policy for recovery of any claim shall arise or be sustained in any court of law or equity unless all the conditions hereof, obligations hereunder, have been complied with (except such of them as may be specifically waived by the Corporation in writing) and unless any proceedings in respect thereof are commenced within two (2) years after the loss could have been determined or the claim arose, and in this respect time shall be the essence of this clause.

24. ARBITRATION

Any question or difference which shall arise as between the Corporation and the Mortgagee concerning this Policy shall at the option of the Corporation be referred to a single arbitrator to be agreed upon by the Corporation and the Mortgagee and in accordance with and subject to the law regarding arbitration in force at the time of the reference in the State or Territory in which the Mortgaged Premises are situated.

25. DEFINITIONS

"Borrower" when not inconsistent with the context shall include a Mortgagor and vice versa. "Mortgage" shall include the mortgage charge, debenture, bill of sale, guarantee and every other document evidencing the loan made to the Borrower or to record the terms of repayment, given by the Borrower and/or Mortgagor to secure ~~the loan. "Mortgagee" when not inconsistent with the context shall include Lender~~ or a Mortgage Manager. "Mortgaged Property" includes the terms Mortgaged Premises and Security. Words importing persons shall extend to and include corporations and words in any genders and words importing the singular or plural number shall extend to and include the plural and singular respectively

26. SPECIAL CONDITIONS

The Terms and Conditions of the Policy have been amended, varied or altered as detailed in the Special Conditions set out in the annexed Schedule.

Appendix K

Mortgage Guaranty Insurance Model Act (U.S.)

In the United States, all form of insurance are regulated by the individual states, not by the federal government. The National Association of Insurance Commissioners, representing the chief insurance regulators of all fifty states, have promulgated a Mortgage Guaranty Insurance Model Act which is enhanced periodically and offered as a recommended framework for each state to consider in supervising its own individual mortgage insurers.

While the specific terms and restrictions of the Model Act may be uniquely applicable to the U.S. environment, most of the topics addressed therein have broad applicability.

MORTGAGE GUARANTY INSURANCE MODEL ACT

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Section 1. Title

This chapter may be cited as the Mortgage Guaranty Insurance Act.

Section 2. Definitions

The definitions set forth in this article shall govern the construction of the terms used in this chapter but shall not affect any other provisions of this code.

A. "Mortgage guaranty insurance" is:

(1) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, provided the improvement on such real estate is a residential building or a condominium unit or buildings designed for occupancy by not more than four families.

(2) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, providing the improvement on such real estate is a building or buildings designed for occupancy by five (5) or more families or designed to be occupied for industrial or commercial purposes.

(3) Insurance against financial loss by reason of nonpayment of rent or other sums agreed to be paid under the terms of a written lease for the possession, use or occupancy of real estate, provided the improvement on such real estate is a building or buildings designed to be occupied for industrial or commercial purposes.

B. "Authorized real estate security" for the purpose of this chapter means an amortized note, bond or other evidence of indebtedness, not exceeding ninety-five percent (95%) of the fair market value of the real estate, secured by a mortgage, deed of trust, or other instrument which constitutes, or is equivalent to, a first lien or charge on real estate; provided:

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(1) The real estate loan secured in such manner is one of a type which a bank, savings and loan association, or an insurance company, which is supervised and regulated by a department of this state or any agency of the federal government, is authorized to make, or would be authorized to make, disregarding any requirement applicable to such an institution that the amount of the loan not exceed a certain percentage of the value of the real estate.

(2) The improvement on such real estate is a building or buildings designed for occupancy as specified by Subsections A(1) and A(2) of this section.

(3) The lien on such real estate may be subject to and subordinate to the following:

(a) The lien of any public bond, assessment or tax, when no installment, call or payment of or under such bond, assessment or tax is delinquent.

(b) Outstanding mineral, oil, water or timber rights, rights-of-way, easements or rights-of-way of support, sewer rights, building restrictions or other restrictions or covenants, conditions or regulations of use, or outstanding leases upon such real property under which rents or profits are reserved to the owner thereof.

C. "Contingency reserve" means an additional premium reserve established to protect policyholders against the effect of adverse economic cycles.

Section 3. Capital and Surplus

A mortgage guaranty insurance company shall not transact the business of mortgage guaranty insurance unless: if a stock insurance company, it has paid-in capital of at least one million dollars ($1,000,000) and paid-in surplus of at least one million dollars ($1,000,000), or if a mutual insurance company, a minimum initial surplus of two million dollars ($2,000,000). A stock company or a mutual company shall at all times thereafter maintain a minimum policyholders' surplus of at least one million five hundred thousand dollars ($1,500,000).

Section 4. Insurer's Authority to Transact Business

No mortgage guaranty insurance company may issue policies until it has obtained from the commissioner of insurance a certificate setting forth that fact and authorizing it to issue policies.

Section 5. Geographic Concentration

A mortgage guaranty insurance company shall not insure loans secured by a single risk in excess of ten percent (10%) of the company's aggregate capital, surplus and contingency reserve.

No mortgage guaranty insurance company shall have more than twenty percent (20%) of its total insurance in force in any one Standard Metropolitan Statistical Area (SMSA), as defined by the United States Department of Commerce.

The provisions of this section shall not apply to a mortgage guaranty insurance company until it has possessed a certificate of authority in this state for three (3) years.

Section 6. Advertising

No mortgage guaranty insurance company or any agent or representative of a mortgage guaranty insurance company shall prepare or distribute or assist in preparing or distributing any brochure, pamphlet, report or any form of advertising to the effect that the real estate investments of any financial institution are "insured investments," unless the brochure, pamphlet, report or advertising clearly states that the loans are insured by mortgage guaranty insurance companies possessing a certificate of authority to transact mortgage guaranty insurance in this state or are insured by an agency of the federal government, as the case may be.

Section 7. Investment Limitation

A mortgage guaranty insurance company shall not invest in notes or other evidences of indebtedness secured by mortgage or other lien upon real property. This section shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contracts of sale are acquired in the course of the good faith settlement of claims under policies of insurance issued by the mortgage guaranty insurance company, or in the good faith disposition of real property so acquired.

Section 8. Coverage Limitation

A mortgage guaranty insurance company shall limit its coverage net of reinsurance ceded to a reinsurer in which the company has no interest to a maximum of twenty-five percent (25%) of the entire indebtedness to the insured or in lieu thereof, a mortgage guaranty insurance company may elect to pay the entire indebtedness to the insured and acquire title to the authorized real estate security.

Section 9. Mortgage Guaranty Insurance as Monoline

A. A mortgage guaranty insurance company which anywhere transacts any class of insurance other than mortgage guaranty insurance is not eligible for the issuance of a certificate of authority to transact mortgage guaranty insurance in this state nor for the renewal thereof.

B. A mortgage guaranty insurance company which anywhere transacts the classes of insurance defined in Section 2B or 2C is not eligible for a certificate of authority to transact in this state the class of mortgage guaranty insurance defined in Section 2A; provided, however, a mortgage guarantee insurance company which transacts a class of insurance defined in Section 2A may write up to five percent (5%) of its insurance in force on residential property designed for occupancy by five (5) or more families.

Section 10. Underwriting Discrimination

A. Nothing in this chapter shall be construed as limiting the right of any mortgage guaranty insurance company to impose reasonable requirements upon the lender with regard to the terms of any note or bond or other evidence of indebtedness secured by a mortgage or deed of trust, such as requiring a stipulated down payment by the borrower.

B. No mortgage guaranty insurance company may discriminate in the issuance or extension of mortgage guaranty insurance on the basis of the applicant's sex, marital status, race, color, creed or national origin.

C. No policy of mortgage guaranty insurance excluding policies of reinsurance, shall be written unless and until the insurer shall have conducted a reasonable and thorough examination of (1) the evidence supporting credit worthiness of the borrower, and (2) the appraisal report reflecting market evaluation of the property and shall have determined that prudent underwriting standards have been met.

Section 11. Policy Forms and Premium Rates Filed

A. All policy forms and endorsements shall be filed with and be subject to the approval of the commissioner. With respect to owner-occupied, single-family dwellings, the mortgage guaranty insurance policy shall provide that the borrower shall not be liable to the insurance company for any deficiency arising from a foreclosure sale.

B. In addition, each mortgage guaranty insurance company shall file with the department the rate to be charged and the premium including all modifications of rates and premiums to be paid by the policyholder.

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C. Every mortgage guaranty insurance company shall adopt, print and make available a schedule of premium charges for mortgage guaranty insurance policies. Premium charges made in conformity with the provisions of this chapter shall not be deemed to be interest or other charges under any other provision of law limiting interest or other charges in connection with mortgage loans. The schedule shall show the entire amount of premium charge for each type of mortgage guaranty insurance policy issued by the insurance company.

NOTE: Open rating states may delete a portion or all of this provision and insert their own rating law.

Section 12. Outstanding Total Liability

A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty-five (25) times its capital, surplus and contingency reserve. In the event that any mortgage guaranty insurance company has outstanding total liability exceeding twenty-five (25) times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds twenty-five (25) times its capital, surplus and contingency reserve. Total outstanding liability shall be calculated on a consolidated basis for all mortgage guarantee insurance companies which are part of a holding company system.

Section 13. Rebates, Commissions and Charges

A. A mortgage guaranty insurance company shall not pay or cause to be paid either directly or indirectly, to any owner, purchaser, lessor, lessee, mortgagee or prospective mortgagee of the real property which secures the authorized real estate security or which is the fee of an insured lease, or any interest therein, or any person who is acting as an agent, representative, attorney or employee of such owner, purchaser or mortgagee, any commission, or any part of its premium charges or any other consideration as an inducement for or as compensation on any mortgage guaranty insurance business.

B. In connection with the placement of any mortgage guaranty insurance, a mortgage guaranty insurance company shall not cause or permit any commission, fee, remuneration, or other compensation to be paid to, or received by any insured lender or lessor; any subsidiary or affiliate of any insured; any officer, director, or employee of any insured or any member of their immediate family; any corporation, partnership, trust, trade association in which any insured is a member, or other entity in which any insured or any such officer, director, or employee or any member of their immediate family has a financial interest; or any designee, trustee, nominee, or other agent or representative of any of the foregoing.

C. No mortgage guaranty insurance company shall make any rebate of any portion of the premium charge shown by the schedule required by Section 11C. No mortgage guaranty insurance company shall quote any rate or premium charge to any person which is different than that currently available to others for the same type of coverage. The amount by which any premium charge is less than that called for by the current schedule of premium charges is an unlawful rebate.

D. The commissioner may, after notice and hearing, suspend or revoke the certificate of authority of any mortgage guaranty insurance company, or in his discretion, issue a cease and desist order to any mortgage guaranty insurance company which pays any commission or makes any unlawful rebate in willful violation of the provisions of this chapter. In the event of the issuance of a cease and desist order, the commissioner may, after notice and hearing, suspend or revoke the certificate of authority of any mortgage guaranty insurance company which does not comply with the terms thereof.

Section 14. Compensating Balances Prohibited

Except for commercial checking accounts and normal deposits in support of an active bank line of credit, a mortgage guaranty insurance company, holding company or any affiliate thereof is prohibited from maintaining funds on deposit with the lender for which the mortgage guaranty insurance company has insured loans. Any deposit account bearing interest at rates less than what is currently being paid other depositors on similar deposits or any deposit in excess of amounts insured by an agency of the federal government shall be presumed to be an account in violation of this section. Furthermore, a mortgage guaranty insurance company shall not use compensating balances, special deposit accounts or engage in any practice which unduly delays its receipt of monies due or which involves the use of its financial resources for the benefit of any owner, mortgagee of the real property or any interest therein or any person who is acting as agent, representative, attorney or employee of such owner, purchaser or mortgagee as a means of circumventing any part of this section.

Section 15. Conflict of Interest

A. If a member of a holding company system, a mortgage guaranty insurance company licensed to transact business in this state shall not, as a condition of its certificate of authority, knowingly underwrite mortgage guaranty insurance on mortgages originated by the holding company system or an affiliate or on mortgages originated by any mortgage lender to which credit is extended, directly or indirectly, by the holding company system or any affiliate.

B. A mortgage guaranty insurance company, the holding company system of which it is a part, or any affiliate shall not as a condition of the mortgage guaranty insurance company's certificate of authority, pay any commissions, remuneration, rebates or engage in activities proscribed in Sections 13 and 14.

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans which have resulted in the conveyance of property which remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of

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reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to fifty percent (50%) of such remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of one hundred and twenty months (120), except that withdrawals may be made by the company in any year in which the actual incurred losses exceed thirty-five percent (35%) of a corresponding earned premiums, and no such releases shall be made without prior approval by the commissioner of insurance of the insurance company's state of domicile.

If the coverage provided in this act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this chapter in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this chapter.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction, in which a mortgage guaranty insurance company subject to the requirement of this act, is also licensed to transact mortgage guaranty insurance, require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of such larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this chapter.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 16A and 16C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.

Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

Legislative History (all references are to the Proceedings of the NAIC).

1976 Proc. II 15, 17, 647, 686, 747-753 (adopted).
1979 Proc. I 44, 47-48, 49, 719, 968-969 (corrected).

Appendix L

"Special Risk" Mortgage Guaranty Fund

The main body of this report deals with mortgage default insurance from the perspective of a self-sustaining, actuarially sound mortgage insurance fund. Notwithstanding the question of public versus private sponsorship, the analysis rests upon the premise that providers of capital for establishing an ongoing mortgage insurance activity in India would require the application of basic insurance tenets regarding risk management, adequacy of premiums and reserves, and long term financial viability.

An alternative mortgage guaranty program model which has been implemented in both developing and industrialized nations entails the creation of a guaranty fund that is not necessarily self-sustaining or actuarially sound, but one which embodies the more limited goal of stimulating mortgage lending to otherwise unserved--typically low income--sectors of the population. For purposes of the following discussion, we shall refer to this alternative model as a "special risk" mortgage guaranty fund.

Because a special risk mortgage guaranty fund does not require positive returns on dedicated capital, such a fund would almost certainly be government sponsored, with any capital shortfalls to be met with public funds. In a developing economy, such a fund might also be created on a pilot basis with initial risk capital provided by an international donor agency such as the World Bank or a domestic agency seeking to stimulate low-income housing production. Although such an experimental fund would serve lower income--and presumably higher risk--homebuyers than would be the case with an actuarially-based mortgage insurer, prudent underwriting and attentive loan servicing would still serve as powerful tools to prevent excessive claims from depleting the fund's capital, except under catastrophic economic conditions.

Field research for this report strongly suggests that India could benefit from the experience of launching a pilot special risk mortgage guaranty fund. Any special risk pilot program should be undertaken separately from the type of mortgage insurance program described in the main body of this report. The special risk program might exhibit the following attributes:

- Borrower income limits, possibly not to exceed the median household income of the area being served. The program ~~might also have fairly restrictive loan amount and/or purchase price limits.~~

- While sponsorship and funding might come from a national source (e.g. NHB or HUDCO), administration and scope, especially during the experimental stages, probably should be local, or possibly limited to a single state. The fund would be largely free of insurance-based mandates for high loan volume and broad risk diversification, while underwriting and servicing success would rest more upon local knowledge and personal involvement by the fund's managers.

- All responsible participants would have some financial stake in the fund's survival. "Participants" in a special risk fund should include not only the fund's government and major

institutional sponsors, but also at the local level one or more cooperative housing lenders and one or more housing-oriented NGOs.

• Local program participants should play an active role both in designing the special risk fund's underwriting parameters, but also in determining which households the program would serve. A membership-driven cooperative entity would be an ideal, if not essential, participant in such a fund in India because: (a) the coop has a unique ability to exert peer group pressure; (b) the coop can evaluate and ameliorate distress situations of individual members in a way that institutional lenders cannot; (c) the financially participating coop (even if on a relatively small scale) would be highly incented to assure the fund's continued benefits to members by aggressively controlling risks associated with both loan underwriting and repayment; and (d) the visible stake of a participating local entity would help avert the moral hazards likely to arise when low-income borrowers perceive the fund to be remote and institutional.

• The fund would enable prospective borrowers to borrow higher amounts for longer terms than they would otherwise be able to do. For the type of borrowers targeted by a special risk fund, the difference would mean the ability to borrow for shelter when heretofore their borrowing capacity was limited to fulfilling more limited, short term needs.

• Stringent mortgage lending rules regarding the pledging of clear property title as loan security might not be so rigorously applied. As a practical matter, the borrower's known repayment habits and general character and local community standing may serve as the primary basis for granting the housing loan with the guaranty. Again, membership in a cooperative organization that is able and willing to back up the borrower's individual loan repayment pledge could be a significant success factor for a special risk fund.

• A borrower-paid guaranty fee should cover the program's administrative costs plus some risk premium, though not necessarily the full catastrophic risk attribution required of a true insurance program. The fee may be kept affordable by adding it to the initial loan balance.

Regarding the structure and operations of such an experimental mortgage guaranty fund, international experience offers no single prescribed template for success.

One possible type of pilot fund might entail a national sponsor with available seed capital soliciting proposals from local applicants. The sponsor might stipulate, for example, that the applicant take the form of a joint venture or consortium consisting of at least one qualified NGO or housing cooperative and at least one community based lender or HFC. The applicant, so defined, would offer to structure a specially created guaranteed loan program, including a designated, qualified program manager, complete with a proposed lending program and budget. The proposal would be required to articulate not only how guaranteed loans would be underwritten and administered, but also how risk would be pooled and how each participating entity would assume an appropriate share of total risk exposure--in addition to the financial risk being assumed by the sponsor. Such risk sharing could entail both a simple segmentation of total risk as well as a hierarchic layering of risk at either the loan level or the risk pool level.

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Upon acceptance of one or more proposals, the national sponsor would then capitalize the special risk fund pursuant to a detailed contract with its joint local or state-level proponents. The national sponsor should not participate in the ongoing management of the pilot guarantee program(s). Fund management should be the contractual obligation of the local joint venture or consortium, subject only to detailed contractual provisions and regular, thorough audit. As a practical matter, the granting of individual loans and individual loan guarantees would probably be a seamless function.

In the event of incurable default, the local program manager would tap the guaranty fund for realized losses. In some cases, the fund might be tapped to restructure, rather than to liquidate a loan outright. Here is where the personal knowledge and stake of local participants may serve simultaneously the fund's social purposes and its need to survive financially in order to serve more future applicants. While the guaranty fund probably should not cover 100 percent of such losses, the percentage of coverage most likely would exceed that of a commercially-driven insurance program.

The inevitable question then arises, "How, specifically, would the presence of such a pilot guaranty fund empower its local sponsors to serve a low-income needy clientele that is not presently being reached?" The answer is twofold:

First, India's community-based thrift and credit societies--even more than the nation's larger HFCs--are thinly capitalized and operate under such narrow spreads that they cannot assume the risks inherent in the higher loan balances and longer terms associated with making mortgage loans to low income applicants. A modest-sized guaranty fund would be able to absorb potentially damaging losses from even a few sizeable loans defaulting, thereby empowering participating community-based lenders to extend housing loans that otherwise simply would not be made.

Second, a guaranty fund cushion creates at least the opportunity for "participation" financing either by some of the larger HFCs, by HUDCO, or conceivably even the NHB. The concept is simple: Institutional participants could purchase undivided, or participating, interests in loans made by community-based lenders with the support of a guaranty fund. The guaranty benefits could be assigned to these third party participating investors so as to make the level of risk acceptable to them, even though they are not active participants in the underwriting and servicing of the individual loans or in the administration of the guaranty fund.

Exhibits L-1 to L-4 portray how this type of experimental guaranty fund might play out under a two different risk scenarios. While the format of these exhibits resembles that of the *pro forma* models presented in the main body of the report, several key variations are to be noted:

- The average insured loans amount is much smaller: 100,000 versus 200,000 rupees.
- The coverage percentage is higher: 50 percent versus 25 percent
- The projected claim incidence rate is higher: 10-15 percent versus 4 percent

- The projected loss severity is higher: 50-75 percent versus 25-50 percent
- A tax rate of zero, rather than the prevailing 45 percent corporate tax rate
- The rate of return is negligible or negative versus significantly positive
- The premium rate (guaranty fee) is lower: 2 percent versus 2.3 to 3.9 percent

All of these variances combined serve to illustrate the key difference between an actuarially-based mortgage insurance program and a special risk mortgage guaranty fund. In particular the assumed levels of loss frequency and severity exceed those one would expect to encounter in a commercially viable lending/insurance program.

The first scenario, summarized in Exhibits L-1 and L-2, demonstrates how a theoretical guaranty fund, or funds, initially funded at Rs.5 million would survive--though not grow--in the face of rather adverse claims conditions. This experiment might be labeled a qualified success, despite its failure to self-fund any growth, because as guaranteed loans pay off, a modest flow of additional guarantees may be issued.

The second scenario, summarized in Exhibits L-3 and L-4, by contrast, illustrates the point at which very negative claims frequency and loss severity would result in eventual depletion of a Rs.5 million mortgage guaranty fund. Despite the gradual loss of the entire initial capitalization, this experiment might not be deemed a total failure, depending on the goals of those who funded the pilot experiment. When viewed as an alternative to providing direct housing subsidies of Rs.5 million, the guaranty fund depicted probably helped more low-income households achieve homeownership than the direct subsidy would have achieved. Furthermore, valuable intelligence regarding low-income mortgage lending would have been secured from this experiment. Based on such experience, it is possible that either the original donor or another agency might choose to continue the program with additional capital infusions and selective program alternations.

In summary, the prospective establishment of a mortgage guaranty fund in support of community-based lending should qualify as a promising use of donor or government seed money in support of low income housing production, particularly when compared with the alternative prospect of channeling scarce housing assistance resources into direct subsidies. The key to successful deployment of such resources in community-based guaranty funds lies in structuring the proper mix of incentive and needs among the various participants, maintaining a localized and personalized orientation, and identifying local program managers and beneficiaries whose training and experience will minimize the likelihood of excessive operating costs or mistakes that result in needless dissipation of fund assets.

Exhibit L-1

Mortgage Guaranty Fund--Baseline Assumptions

Breakeven Scenario

Insured loan amount	100,000
Coverage percent	50%
Total claims frequency	10%
Loss severity rate	50%
Investment rate of return	10%
Overhead cost per policy	500
Risk-to-capital ratio	10:1
Tax rate	0
Initial premium rate	2.0%
Renewal premium rate	0
Internal rate of return	1.6%

Exhibit L-2

Mortgage Guaranty Fund--Projected Performance

Breakeven Scenario

Year	Cash Revenues	Cash Expenses	Cash Income	Cumulative Cash Income
1	2338	275	2063	2063
2	683	775	(93)	1970
3	643	1525	(883)	1087
4	545	1175	(630)	457
5	448	775	(328)	129
6	360	425	(65)	64
7	285	225	60	124

Exhibit L-3

Mortgage Guaranty Fund--Baseline Assumptions

Fund Depletion Scenario

Insured loan amount	100,000
Coverage percent	50%
Total claims frequency	**15%**
Loss severity rate	**75%**
Investment rate of return	10%
Overhead cost per policy	500
Risk-to-capital ratio	10:1
Tax rate	0
Initial premium rate	2.0%
Renewal premium rate	0
Internal rate of return	**-9.1%**

Exhibit L-4

Mortgage Guaranty Fund--Projected Performance

Fund Depletion Scenario

Year	Cash Revenues	Cash Expenses	Cash Income	Cumulative Cash Income
1	2384	306	2078	2078
2	823	1713	(889)	1189
3	808	3400	(2592)	(1403)
4	664	2613	(1949)	(3352)
5	519	1713	(1193)	(4545)
6	398	925	(528)	(5073)
7	304	475	(171)	(5244)
8	227	250	(23)	(5267)
9	161	138	24	(5243)

Appendix M

List of Interviewees

INDIA

Bakeri Engineers & Industries Ltd., Ahmedabad
Pavan Bakeri, Director
Anil R. Bakeri

CanFin Homes Ltd., Bombay
K. Gopinath, Chief Manager

The Credit Rating Information Services of India Ltd. (CRISL), Bombay
G. S. R. K. Rao, Executive Director & Chief Rating Officer
D. Thyagarajan, Assistant General Manager

Friends of Women's World Banking, Ahmedabad
Ms. Vijaya Lakshmi Das, Director

GIC Housing Finance Ltd., Bombay
Vijay Joshi, Chief Executive
Madhusudan Parkhi, Group Head

GRUH Finance Limited, Ahmedabad
Sudhin Choksey, General Manager
Kamlesh Shah, Chief Manager-Operations & Accounts

ICRA Limited (Investment Information & Credit Rating Agency), Bombay
Shobhit Mehrotra, Credit Rating Analysy

Indo-US Housing Finance Expansion Program, New Delhi
Richard Genz, Director
M. R. Prabhakar, Senior Advisor

Housing Development Finance Corporation, Bombay
Conrad D'souza, Chief-Management Services
Paresh Parasnis, Regional Manager
Satish Mehta, General Manager-Business Development
Tasneem Kadwani, Senior Officer-Operations

Housing and Urban Development Corporation Ltd. (HUDCO), New Delhi
S.C. Sharma, Executive Director
Krishna Murthy, Advisor

Kalpataru Corporate Services Limited, New Delhi
S. Swaminathan, Consultant; former Regional Manager, Canfin Homes

LIC Housing Finance Ltd., Bombay
E. I. Thomas, General Manager

National Housing Bank, New Delhi
S. P. Ghosh, Chief General Manager & Secretary
R. V. Verma, Deputy General Manager
K. Muralidharan, Regional Manager

Prarthana Construction Pvt. Ltd., Ahmedabad
B. R. Sabharwal, General Manager
Sai Yoganand R., Sales & Marketing Manager

Rajiv Gandhi Institute for Contemporary Studies
Abid Hussain, Vice Chairman; former Ambassador to the U.S.

Shri Mahila Sewa Sahakari Bank (Self-Employed Women's Association)
Ms. Jayshree Vyas, Managing Director

USAID, New Delhi
C. Lindsay Elmendorf, Deputy Director

Vikas Center for Development, Ahmedabad
Rajesh Shah, Executive Secretary

UNITED STATES:

America's Community Bankers, Washington DC
(formerly United States League of Savings Institutions)
James Christian, Chief Economist (retired)
Phillip Gasteyer, General Counsel
Norman Strunk, Executive Director (retired)

Federal Home Loan Bank System
Robert Bartel, former President, Federal Home Loan Bank of San Francisco

Federal National Mortgage Association, Washington DC
H. Beth Marcus, Managing Director of International Housing Finance Services
Isaac F. Megbolugbe, Managing Editor-Journal of Housing Research
Catherine Re, International Housing Finance Services

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GE Capital Mortgage Insurance Corporation, Raleigh NC
Ms. Tracy Colores, Vice President
Ms. Janneke Ratcliffe, Vice President

International Union of Housing Finance Institutions, Chicago
Dale Bottom, Secretary-General (retired)
Michael J. Lea, Director of Research

Mortgage Asset Research Institute, Inc. (MARI), MacLean VA
D. James Croft, Executive Director

Mortgage Guaranty Insurance Corporation (MGIC), Milwaukee WI
Leon T. Kendall, former Chairman

CANADA:

Canada Mortgage and Housing Corporation, Ottawa
Douglas Dennis

GE Capital Mortgage Insurance Canada, Toronto
Edward Machej

Mortgage Insurance Company of Canada (MICC), Toronto
Andrew Donnelly

AUSTRALIA & NEW ZEALAND:

Commercial Union Australia Mortgage Insurance Corporation Ltd., Sydney
Eric Bowell, Deputy General Manager

HONG KONG:

Hong Kong Housing Authority
Roger Avon, Assistant Director of Finance

OTHER SOURCES:

European Community Mortgage Federation, Brussels
Judith Hardt, Secretary General

GE Capital Mortgage (UK) Ltd., London
David B. Curren, Managing Director

Home Insurance and Guaranty Corporation, Manila
Wilfredo F. Hernandez, General Manager

The Swedish National Housing Finance Corporation
Sune Jussil, Director

Roger F. Blood

Mr. Blood is a Senior Associate with Mercer Management Consulting, Inc., a general management consulting affiliate of the Marsh & McLennan Companies. A member of the firm's Financial Services Industry Practice, Mr. Blood specializes in residential mortgage finance.

Prior to joining Mercer in 1986, Mr. Blood served for ten years as senior vice president—risk management for a nationwide private mortgage insurance firm. He has also been active in MICA, the mortgage insurance industry trade association, since its inception in 1974.

Mr. Blood received a B.A. from Clark University and an M.B.A. in real estate finance from the Wharton Graduate Division of the University of Pennsylvania.