

CRS Report for Congress

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Private Mortgage Insurance: Cancellation Options

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Summary

If home mortgage borrowers are unable to make downpayments of at least 20%, lenders generally require that the borrowers obtain some type of mortgage insurance. In response, the borrowers either obtain private mortgage insurance (PMI) from mortgage insurers or, when eligible, insurance from a federal government agency. In recent years, the majority of borrowers who need mortgage insurance have obtained PMI.

The purpose of PMI is to protect the lender or secondary market investor from loss if the borrower defaults on a low-downpayment loan. As the borrower's equity in the property increases, the risk of default decreases. The lender's or investor's risk of loss decreases as the borrower's equity increases, and a point is reached where the mortgage insurance is no longer justified by risk.

Reportedly, however, there is widespread industry practice of requiring and collecting mortgage insurance premiums from borrowers when it is no longer necessary. In some cases, the insurance could be discontinued, but the burden is placed on the borrowers to request cancellation, and the borrowers are not aware of that option. No federal law requires disclosure of the option.

In the 105th Congress, legislation has been passed by the House and Senate to address the issue. As passed by the House, H.R. 607 would amend the Real Estate Settlement Procedures Act to require disclosure to the borrower of any rights to cancel mortgage insurance, and would provide mandatory disclosure once the loan had a 75% loan-to-value ratio. As passed by the Senate, H.R. 607 and S. 318 would require disclosure of the right to cancel mortgage insurance and provide for mandatory cancellation once a 78% loan-to-value ratio was achieved. The differences between the bills may be resolved during conference.

Background

Generally, lenders require that borrowers make downpayments of at least 20% of the home price in order to obtain mortgage loans. If a borrower is unable or unwilling to make downpayments of at least 20% of the home price, then some type of mortgage insurance or guarantee is required. This insurance may take one of several forms: (1) the borrower may obtain mortgage insurance (which is generally referred to as private mortgage insurance or PMI) from an insurance company, (2) the borrower may obtain insurance from the Federal Housing Administration (FHA), (3) if eligible, the borrower may obtain a Department of Veterans Affairs (VA) home loan guarantee, or (4) if eligible, the borrower may obtain a direct or guaranteed loan from the Department of Agriculture. In either case, the insurance enables the borrower to obtain a loan that would not otherwise be available, or to obtain a loan on terms that would not otherwise be permissible. PMI and FHA are often the only options for most borrowers who need mortgage insurance.

Over the past 10 years, on average, more than 74% of the dollar volume of mortgages originated on 1- to 4-family homes have not required any mortgage insurance. Uninsured loans have ranged from 64% to 80% of the dollar volume of loans originated in each of the past 10 years. So, by dollar volume, insured loans appear to be a relatively small part of the mortgage market. But that may be misleading. In 1995, for example, insured loans represent only about 29% of the dollar volume of mortgages originated, but they represent nearly 1.8 million loans. So, mortgage insurance appears to be important for a large number of borrowers.

The FHA home loan insurance program was begun in the 1930s, when lenders had largely withdrawn from the mortgage market. The program was designed to encourage lenders to begin making long-term mortgage loans again. FHA agreed to pay for the lenders' losses if the borrowers defaulted on the loans.

In the 1950s, private insurers saw the value of providing a similar service to the higher end of the mortgage market (FHA-insured loans are generally limited to 95% of an area's median home price). By the 1970s, private insurers were originating a larger volume of loans than FHA. That changed in the late 1980s when the private insurers tightened their underwriting standards because of the large losses the industry was experiencing. From 1986 until 1990, FHA wrote a larger volume of loans than the private insurers. Since 1991, the private insurers have again been producing the largest volume of insured loans.

Canceling Mortgage Insurance

If lenders do not require mortgage insurance on a loan on which a borrower makes a downpayment of at least 20%, it would seem reasonable to permit the cancellation of mortgage insurance for the borrower who accumulates equity of at least 20% in the mortgaged property. In fact, 6 states — California, Connecticut, Hawaii, Maryland, Minnesota, and New York — require that lenders disclose to borrowers when the borrowers have accumulated equity of 20% of the original value of the home, and that lenders disclose that PMI may be canceled once that prescribed equity threshold is reached.

Most mortgage loans are sold in the secondary market. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), the two giants of the secondary market, permit the cancellation of PMI.

Fannie Mae is in the process of modifying its guidelines regarding the conditions to be met on loans that Fannie Mae purchases. At the time of loan origination and annually, borrowers must be informed that their PMI may be canceled if certain conditions are met. The mortgage insurance may be canceled when a borrower with a good payment history accumulates equity in the home that is equal to 20% of the home's original value, whether the equity was accumulated through prepayment of part of the loan or amortization of the loan. When a loan reaches its "half-life" (15 years on a 30-year mortgage and 7.5 years on a 15-year mortgage) and the loan is current, the mortgage insurance will be automatically canceled.

Freddie Mac also has guidelines regarding the requirements to be met on loans that Freddie Mac purchases. The guidelines require a lender to cancel PMI in response to a request from the borrower if certain conditions are met. The lender has one of three options to choose in determining the loan-to-value (LTV) ratio. Under option 1, the LTV ratio must be 80% or less of the current appraised value and (1) 2 years must have elapsed since the loan was originated, and (2) the increase in value must be attributable to improvements made to the property since the loan was originated. Under option 2, the LTV must be 80% or less of the original value and (1) 2 years must have elapsed since the loan was originated, (2) the 80% LTV was reached as a result of payments on the principal, and (3) the lender certifies that the current value is at least equal to the original value. Under option 3, the LTV ratio must be 75% or less of the current appraised value, and 2 or more years but less than 5 years must have elapsed since the loan was originated.¹ The borrower may not have been 16 to 29 days delinquent more than once in the 12-month period preceding the request for PMI cancellation. If the mortgage is an adjustable rate mortgage or a graduated payment mortgage, at least 12 months must have elapsed since the last increase in monthly payments.

The purpose of PMI is to protect the lender or secondary market investor from loss if the borrower defaults on a low-downpayment loan. If circumstances prevent the borrower from continuing to meet the mortgage loan obligations and the borrower has little equity in the mortgaged property, the borrower is likely to default on the loan. The transaction costs of selling the property may exceed the borrower's equity. As the borrower's equity in the property increases, the risk of default decreases. If circumstances prevent the borrower from continuing to meet the mortgage loan obligations and the borrower's equity in the mortgaged property exceeds the transaction costs of selling, the borrower is more likely to exercise the option of selling the property rather than default on the loan. The lender's or investor's risk of loss decreases as the borrower's equity increases and a point is reached where the mortgage insurance is no longer justified by risk to the lender.

Reportedly, there is widespread industry practice of requiring and collecting mortgage insurance premiums from borrowers when it is no longer necessary. Since the

¹ These LTV ratios apply to owner-occupants or second home owners. For investors the LTV ratios are 65% for option 1 or 2, and 60% for option 3.

protections that PMI offers flow to parties that are not paying the insurance, market discipline does not necessarily address the problem. In some cases the insurance could be discontinued, but the burden is placed on the borrowers to request cancellation, and the borrowers are not aware of that option. No federal law requires disclosure of the option. Fannie Mae and Freddie Mac have guidelines permitting PMI cancellation, but in the past neither agency has required disclosure of the option. As mentioned above, Fannie Mae plans to amend its guides to require disclosure.

Borrowers could be paying \$240 to \$1,200 annually for mortgage insurance that is no longer needed. Dozens of class action law suits have been filed against lenders for failure to make that disclosure. Legislation has been introduced in the 105th Congress to address the issue.

Summary and Comparison of Federal Legislation

The Homeowners Insurance Protection Act (H.R. 607) was introduced by Representative Hansen on February 5, 1997. Hearings were held on the bill on March 18, 1997. A mark-up session was held on March 20, 1997, by the Committee on Banking and Financial Services, and the bill was amended and ordered to be reported. The bill was passed by the House on April 16, 1997.

The Homeowners Protection Act of 1997 (S. 318) was introduced by Senator D'Amato on February 12, 1997. Hearings were held on the bill on February 25, 1997. The bill was amended and reported by the Committee on Banking, Housing, and Urban Affairs on October 23, 1997. It was passed by the Senate on November 9, 1997. On November 13, 1997, the Senate amended and passed H.R. 607. As passed by the Senate, H.R. 607 includes three titles, and Title II incorporates the language of S. 318.

In the remainder of this report, all mention of the Senate version of H.R. 607 will be referring to Title II of that bill. The House-passed bill and the Senate-passed bill will simply be referred to as the House bill and Senate bill, respectively.

The House bill would amend RESPA while the Senate bill is a "stand-alone" bill which would not amend any existing law. Thus, a change in HUD regulations would be required to implement the House bill, while the Senate bill could be implemented without any change in federal regulations.

The House bill would give borrowers the right to terminate PMI once the borrowers have met the conditions and procedures that lenders have required for such termination. The bill does not specify those conditions except to state that the conditions must be reasonably related to the purposes for which the lenders had imposed the PMI requirement.

Under the Senate bill, lenders would be required to terminate PMI upon written request by the borrowers whose loan balances have reached 80% of the original property value. Certain conditions would have to be met. (1) Borrowers would have to have good payment histories as defined in the bill. (2) Borrowers would have to satisfy any lender requirement for evidence that the value of the property had not declined below the original value, and for certification that the equity in the property were not encumbered by subordinate liens. Report language indicates that the bill is not intended to create a

20% minimum equity requirement for PMI cancellation, but that it creates a floor and lenders may not impose more restrictive requirements.

The House bill would require the mandatory termination of PMI obligations once the loan balance is 75% of the lesser of (1) the original purchase price of the property or (2) the original appraised value of the property. If borrowers were delinquent in their payments, the PMI would not be canceled until one month after the borrowers become current in their payments.

The Senate bill would provide for automatic termination of the PMI requirement once the loan balance reaches 78% of the original property value. The borrowers would have to be current in their mortgage payments. Additionally, the bill would provide that PMI would no longer be required once the loans reached their half-life, if the borrowers were current on their payments. Exceptions would be provided for loans defined as high risk under guidelines published by Fannie Mae and Freddie Mac, or under identical guidelines determined by lenders. Under such loans, lenders would not be required to cancel the PMI requirement upon the request of the borrowers, and the PMI requirement would not terminate when the borrowers achieved 78% equity in the properties. For these high risk mortgages the PMI requirement would terminate at the half-life of the loans if the payments were current.

The Senate bill would also provide an exception from PMI cancellation on loan transactions on which the PMI is paid by someone other than the borrowers. On certain transactions, for example, the borrowers may pay higher than market interest rates, and obtain loans under which the borrowers do not pay any discount points or PMI. In effect, these costs are built into the interest rates and capitalized over the life of the loans. To subject such loans to PMI cancellation would be to penalize the lenders who make the loans and pay the costs on behalf of the borrowers. Thus, lenders would be discouraged from offering a loan product that has been useful to borrowers with limited up-front funds. The bill provides that such loans would not be subject to borrower-initiated or automatic PMI cancellation. The bill would require that lenders provide such borrowers with written notice: (1) that the borrowers have no statutory right to request PMI cancellation, while borrowers under other loan programs have such rights in addition to automatic PMI termination at some point; (2) that the loans usually result in higher interest rates than would otherwise be required, and that PMI is terminated only when the loans are paid off or refinanced, (3) that there are advantages and disadvantages to the loan program, and (4) that the costs may be tax deductible.

The House bill would require lenders to provide written disclosures to borrowers to inform them whether PMI would be required, the period during which PMI would be required to be in effect, and the conditions to be met for the insurance to be terminated. If PMI were required, then lenders would have to give the borrowers any of the following notices, if applicable.

One notice would inform borrowers that PMI obligations may be terminated upon request of the borrowers. Borrowers would be informed that at least annually the servicers would provide them with the address and toll-free or collect telephone number that the borrowers could use to contact the servicers and determine whether PMI could be terminated, and the conditions and procedures for terminating PMI. Another notice would inform borrowers that the PMI requirement would terminate by law when the loan

balance is 75% of the lesser of (1) the original purchase price of the property or (2) the original appraised value of the property. Such notices must be provided at no cost to the borrowers.

Lenders would be required to annually provide this notice of the right to cancel the insurance and the conditions to be met for such cancellation. Once the borrowers have met the disclosed conditions, lenders would be required to cancel the insurance at the borrowers request.

The Senate bill would require several disclosures for newly originated loans. Except for high risk loans, lenders would be required to provide the borrowers with written amortization schedules. Additionally, borrowers would be provided with written notice: (1) that the borrowers may cancel the PMI obligation once an 80% loan-to-value ratio (LTV) has been achieved, and indicating the date on which such cancellation may be requested based upon the amortization schedule; (2) that the borrowers may cancel the PMI at an earlier date once an 80% LTV is achieved based upon actual payments; (3) that the PMI requirement will automatically terminate when a 78% LTV is achieved, and indicating the cancellation date; and (4) that there are exemptions to these cancellation requirement and indicating whether such exemptions apply in these cases . For high risk loans, lenders would be required to provide written notice that PMI may not be required beyond the half life of the loans, if the loans are current. On all newly originated loans, servicers would be required to provide borrowers with annual statements disclosing the rights of the borrowers to cancel the PMI, and the address and telephone number the borrowers may use to determine that information. On existing mortgages which required PMI, servicers would be required to provide annual written statements which disclose that PMI may be canceled under certain circumstances, and provide the address and telephone the borrowers may use to contact the servicers.

The provisions of both bills would become effective one year after enactment, and the automatic cancellation provisions would only apply to newly originated loans.