# ANNEX B

# The Role of Insurance in Home Mortgage Finance in the United States

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# THE ROLE OF INSURANCE IN HOME MORTGAGE FINANCE IN THE UNITED STATES

## Background

The re-establishment of full private property rights in Poland will enable the private sector to play a key role in producing the housing required to meet the nation's current and future needs. A fully functioning housing finance system will also emerge as an integral part of Poland's larger financial sector.

An important corollary to the emergence of a mortgage banking function for housing will be the establishment of appropriate mortgage-related insurance services within the context of Poland's expanding private insurance industry.

Those who are responsible for implementing this growth in mortgage lending and related lines of insurance will look to successful "best practices" in other developed nations for potential models from which to adapt a system specially tailored to meet Poland's own unique needs.

## Introduction

As with all private sector institutional investors in the United States, providers of capital for home mortgages require substantial assurance that their full investment will be repaid with interest when and as agreed. These mortgage capital providers rely primarily upon the willingness and ability of the home mortgage borrower to meet his repayment obligations and, in turn, upon the faithful performance of the mortgage loan servicer (administrator) in remitting all scheduled payments to the investor holding the mortgage loan or mortgage-backed security.

Should the borrower (mortgagor) fail to fulfill his repayment obligations, the value of the individual home securing the mortgage may be called upon through a foreclosure action to repay any outstanding debt that is in default. Other collateral or the credit of a third party, such as a family member, also may be pledged to enhance the security value of the mortgage loan.

The quality of mortgage investments in the U.S. also are supported by means of third party evaluations or ratings of the principal parties involved in the mortgage transaction. Such added support is provided, for example, via credit reporting on the individual borrower and certification of lender and servicer capability by regulators, investment rating agencies and standard-setting secondary mortgage market enterprises.

Notwithstanding the financial strength and capabilities of these direct and indirect participants in the U.S. home financing sector, many risk factors remain which cause the failure of some home mortgages to return their full principle and interest as required. For this reason, there has emerged in the U.S. over many decades a range of insurance products and services expressly designed to minimize such risks. Those insurance products are the subject of this report.

The evolution and refinement of these special insurance services has accelerated over the most recent 25 years. Collectively, these insurance services offer critical risk management support for the private secondary market for home mortgages, which now also provides an open pipeline to the nation's capital markets via highly rated mortgage-backed securities.

Although the U.S. federal government has provided key support in assuming certain mortgage-related risks critical to development of the secondary mortgage market, had the private insurance industry not developed the expertise and financial capacity to underwrite most of these mortgage-related risks, the volume of private capital investment currently flowing into home mortgage lending would be greatly restricted, and the cost of such financing for the individual home buyer, notably greater.

What are the significant mortgage risk factors that have been mitigated by specific insurance lines? See Table B.1, below.

**Table B.1**

| Mortgage Risk Factor | Insurance Line Mitigating Risk |
|---|---|
| Borrower fails to make loan payments, defaults. Value of foreclosed property is insufficient to pay off the outstanding debt. | Mortgage guaranty insurance |
| Payments received on loans in a mortgage pool fail to produce cash flow needed for required payments on mortgage-backed security. | Cash flow insurance<br>Financial guaranty insurance |
| Value or marketability of the property securing mortgage is compromised by a defect in the title. | Title insurance |
| Mistakes by the loan closing agent compromise the value/integrity of the newly created mortgage security. | Title/closing agent's E&O insurance |
| Failure of the mortgage servicer to perform necessary actions to maintain the investment quality status of the mortgage. | Errors & omissions insurance (E&O)<br>Mortgage impairment insurance |
| Dishonest or criminal acts by the mortgage lender/servicer's personnel causing the mortgage instrument to lose its value. | Mortgage bankers or financial institution fidelity bond |
| Condominium regime with many mortgage loans faces insolvency due to dishonest actions of management. | Special fidelity insurance for condominiums |
| Failure of the mortgage lending and servicing institution's management to fulfill their fiduciary obligations. | Directors and officers liability insurance (D&O) |
| Value of the property securing the mortgage is reduced by fire, other physical damage, or related perils. | Homeowners' property insurance with mortgagee endorsement<br>Force-placed property insurance |
| Loss of value of properties owned by lender as a result of foreclosure (RED) due to fire or other physical damage. | Lenders' RED property insurance |
| Value of property securing the mortgage is reduced by flood damage. | Homeowners flood insurance |

| | |
|---|---|
| Mortgagor is unable to make scheduled monthly payments due to death or disability. | Mortgage redemption life and mortgage disability insurance |
| Construction loan borrower is unable to complete large multifamily housing project and defaults on loan | Mortgagor's completion bond |

This report profiles the various lines of insurance as they are structured to support the home mortgage financing system in the United States, a system that is efficient, complex and experience-tested. The discussion of each line is, of necessity, abbreviated and general; each line is the subject of extensive regulation, a myriad of coverage terms and conditions and costs, and subject to ever-changing market conditions, needs and risk factors.

In general, mortgage related insurance in the U.S. today is driven mainly by the needs of the secondary mortgage market, including the two dominant government sponsored, privately capitalized enterprises (GSE's) known as Fannie Mae and Freddie Mac, and a wide range of institutional holders of residential mortgage-backed securities.
Baseline standards for much of this insurance support are set forth by the GSE's and leading investment rating agencies such as Standard & Poor's, Moody's and Duff & Phelps. Such standards may include: (1) the type and amount of coverage needed for an individual mortgage loan or a mortgage-backed security representing a large pool of individual loans, and (2) the minimum claims-paying capacity rating of the private sector insurer providing the coverage, as bestowed either by the investment rating agency in the case of financial guaranties or Best's in the case of other lines.

The purpose of this overview is to provide insight as to why and how each of these insurance lines functions as an integral component of the nation's housing finance system. The order of presentation is not intended to suggest any established levels of priority or importance, either in the U.S. or, prospectively, in Poland.

**Mortgage guaranty insurance**

Mortgage guaranty insurance protects against lender or investor loss by reason of borrower default (credit failure), accompanied by insufficient recoverable value in the property securing the insured loan.

Mortgage guaranty exhibits characteristics of both standard casualty insurance and surety lines. All insurance in the United States is state regulated, and mortgage guaranty may be classified differently in different states. However, it is typically classified as a specialized form of credit insurance within the larger family of casualty lines. Of particular note is the fact that mortgage guaranty covers risks that are sufficiently unusual and catastrophic that this line is the subject of a special set of insurance regulations and reserving requirements and is, furthermore, required to be provided by monoline insurance companies.

Key mortgage guaranty underwriting considerations relate to:
1. the borrower's repayment prospects, based upon
    —credit history
    —income
    —employment record
    —the value and marketability of the residential property securing the mortgage loan
    —local housing and job market conditions
    —the loan instrument features, e.g. fixed versus variable rate
2. the borrower's cash equity and ratio of the loan amount to the value of the home (loan-to-value ratio).

There is a standard mortgage guaranty insurance policy form, including terms and conditions of coverage that are approved by the two leading secondary market agencies—Fannie Mae and Freddie Mac—and state regulators.

Key policy provisions include:
—the loan originator and servicer must be qualified by the insurer
—the policy is noncancellable by the insurer for the life of the loan
—coverage includes (up to specified percent of total) principle, interest, legal and other foreclosure costs, delinquent taxes and insurance premiums, required property maintenance
—following default, the property must be foreclosed and clear title tendered to the insurer to perfect a claim.

Coverage exclusions include:
—fraud or material misrepresentation by the loan originator
—title defects or prior liens
—severe damage to the property, including fire, natural disaster
—undisclosed environmental contamination
—uncompleted construction
—servicer negligence
—lender modification of loan terms or surrender of rights vis a vis the borrower.

Mortgage guaranty coverage from a private insurance carrier generally is required whenever the borrower's down payment is less than 20 percent (i.e. when the loan-to-value ratio is greater than 80 percent) and the loan is to be sold by the originator to a third party investor in the secondary market. Alternatively, a home mortgage loan must carry government-provided mortgage insurance ("FHA") whenever a loan is to be placed in a mortgage pool in support of a government-guaranteed mortgage-backed security ("GNMA"), regardless of loan-to-value ratio.

The two secondary market GSE's—Fannie Mae and Freddie Mac—stipulate the amount of insurance that must be carried on individual mortgage loans. The higher the loan-to-value ratio, the greater the percent of mortgage default insurance that must be carried. In addition, the GSE's establish minimum insurer claims-paying qualifications or ratings that are required for a mortgage guaranty insurer to be eligible under their mortgage purchase programs.

This coverage against loss resulting from borrower default is purchased by the lender, who is the named insured. The insurance cost, however, is passed through to the homebuyer, typically as part of his monthly payment. The insurance coverage is retained, and the borrower continues to pay the premium for a predetermined period of time, but not normally the full life of the loan. Coverage is generally terminated when the loan is paid down to 80 percent loan-to-value ratio.

While borrowers do not benefit directly from mortgage guaranty insurance protection, they do benefit indirectly by being able to purchase a home—typically a first home—with a considerably lower accumulation of savings than would otherwise be required.

Insurance policy claims benefits normally follow the loan as it is sold to the secondary market investor, even while the policy itself is retained and administered by the loan administrator.

Key factors affecting the cost of mortgage guaranty insurance include
—loan amount
—loan-to-value ratio
—type of loan instrument, i.e. fixed versus variable rate/payment
—amount of coverage as a percentage of the total loan amount.

Normally there is no first dollar insurance deductible, as is common with other insurance lines. Insurance exposure starts with the first dollar of losses and extends to a designated percentage of the total loan amount, typically the 'top' 25 to 35 percent. Actual premium charges vary greatly according to the above and other variables, but the average annual policy cost today runs roughly 0.50 to 0.70 percent of the total insured loan amount.

The mortgage insurance business is highly cyclical in terms of volume and profitability. Currently, about one of every seven mortgage loans on single homes is privately insured against borrower default—roughly the proportion with down payments less than 20 percent. The mortgage insurance industry, after suffering devastating losses in the 1980's, recently has enjoyed 15 to 20 percent returns on capital, with losses as a percent of earned premium averaging about 40 percent.

Alternative forms of protection comparable to that provided by mortgage guaranty may be employed, although the historical results are uneven. Such alternatives include: (1) lender self-insurance (with or without a segregated loss reserve), and (2) retention by the originating lender of a subordinated interest—either in the individual loan or, more typically, in a pool of loans—which interest serves as a loss reserve protecting the secondary market investor who holds a senior interest.

Private mortgage guaranty insurance in the United States is written by fewer than ten companies. The leading providers include:
—Mortgage Guaranty Insurance Corporation
—GE Capital Mortgage Insurance Corporation
—United Guaranty Corporation, a subsidiary of AIG
—Republic Mortgage Insurance Company, a subsidiary of Old Republic International
—PMI Mortgage Insurance Company
—Commonwealth Mortgage Assurance Company

**Cash Flow and Financial Guaranty Insurance**

Cash flow insurance is a corollary coverage to mortgage guaranty insurance that is especially important to institutional investors in mortgage-backed securities. These investors are relying upon the timely, as well as the ultimate, repayment of their invested capital.

Mortgage guaranty insurance, whether provided by private insurance firms or the government, basically assures only the ultimate repayment of the debt. It does not cover scheduled monthly payments, which are not received from the borrower during the period from initial borrower default to eventual foreclosure and property resale.

Although private insurers today do not normally provide such cash flow insurance, investor requirements for timely payment are satisfied by timely payment guarantees on their mortgage-backed securities from Fannie Mae and Freddie Mac or, alternatively by the federal government's GNMA cash flow guaranty in the case of government securities backed by pools of mortgages loans that carry government-sponsored (FHA) mortgage guaranty insurance.

Financial guaranty insurance guaranties the timely payment of principal and interest, as well as ultimate repayment, on privately issued mortgage-backed securities that are not issued by Fannie Mae or Freddie Mac.
Financial guaranty insurance, like mortgage guaranty insurance, is regulated as a special form of credit insurance, with special state insurance regulations and a monoline requirement. Financial guaranty carriers are authorized to insured a wide range of debt and asset-backed securities, including securities backed by pools of home mortgages. To the extent that these mortgage pools may contain individual loans that require mortgage guaranty insurance protection, then the ultimate investor is protected by a combination of both mortgage guaranty and financial guaranty coverages.

Several U.S. firms currently provide financial guaranty insurance, including:
—FGIC Corporation, a subsidiary of GE Capital
—Financial Security Assurance Corporation (FSA)
—Capital Markets Assurance Corporation (Cap Mac)
—MBIA Corporation

## Title Insurance

Title insurance for mortgage lenders and investors provides a guarantee that they have a valid and enforceable lien on the residential real estate covered by the policy, including the priority of their lien relative to others. Title coverage assures that, in the event of borrower default and foreclosure, the value of the underlying property serving to secure the mortgage loan will not be lost as a result of a title defect or an undisclosed encumbrance that interferes with the realizable value or marketability of the property.

Homeowners' title insurance, a companion product for lenders' title insurance, provides assurance that the value of owners' financial interest in their homes will not be jeopardized by unknown title defects and encumbrances.

From a regulatory standpoint, title insurance constitutes its own line. As with mortgage guaranty, title insurance is written and regulated as a monoline form of insurance with special regulations applying. Unlike mortgage insurance but similar to surety lines, title insurance is a loss prevention line of insurance where most of the underwriting costs are attributable to retrospective research which enables future risk to be minimized.

Key underwriting considerations involve the maintenance of, and access to, current and accurate records of title to real property and the thorough research of such records in the course of issuing an individual title insurance policy. Given that such underwriting is the norm, title insurer loss ratios normally run well under 10 percent, compared with 80 percent or more for most property and casualty insurers.

Title insurers operate with a standard policy form, promulgated by the American Land Title Association. The ALTA form is universally accepted by primary and secondary mortgage market lenders and approved by insurance regulators in the 50 states.

The types of risks caused by title defects and encumbrances that can be covered by title insurance include:
—fraud
—errors in public records
—undisclosed mechanics', tax and other liens
—forged deeds
—unknown heirs
—false affidavits
—forged release of mortgages
—lack of legal access

The title policy covers both the costs of defending challenges to title validity and losses that may ultimately result. Once issued, the policy automatically extends for the life of the loan and through any resultant foreclosure proceedings.

Coverage exclusions include:
—governmental regulations, e.g. building codes and zoning bylaws, which restrict property usage or improvements
—public taking by eminent domain
—title defects, liens or encumbrances known by the insured or occurring after policy issuance

—invalidity or unenforceability of the lien due to lender violation of usury, consumer protection or lending disclosure laws
—loss of lien priority or status as a result of the operation of certain bankruptcy and other creditors' rights laws.

Title insurance coverage for home mortgage loans generally is required by the secondary mortgage market, including Fannie Mae and most institutional investors and securitizers of mortgage loans. Freddie Mac may accept an attorney's opinion of title with indemnification by the attorney. Title coverage is usually required by mortgage lenders that do not sell into the secondary market, although an attorney's opinion of title is accepted in some areas. Lender's title insurance is always required on condominium properties where there is common area ownership.

Supplemental title insurance purchased by and for the borrower/homeowner is always optional.

Coverage is purchased by the originating lender, with the one-time premium cost passed through to the homebuyer as part of the overall loan closing costs. The lender is the insured policyholder, but when the home loan is sold in the secondary market, the title coverage is assigned to the investor, along with the mortgage itself. All these aspects of the title insurance transaction are the same as mortgage guaranty insurance, except for the method of premium payment; the title insurance premium is paid as one up-front lump sum, while mortgage insurance is paid monthly or annually by the borrower over a number of years.

The cost of a title insurance policy varies considerably according to different state jurisdictions, while premium rates for home loans tend to be quite uniform within states. The premium amount for lenders' coverage, then, varies directly with the size of the insured loan, with the national average running about $3.50 per $1,000 loan amount. Individual states, however, may permit costs for comparable title policies to be more than double the national average. Owners' coverage, when purchased as an adjunct to the lender's policy, may be acquired for an additional $0.50 to $1.00 per $1,000 of total coverage.

Alternative forms of coverage generally are not acceptable in the U.S. mortgage market today. Traditionally, the integrity of title to a mortgaged home was certified—though not insured—by the attorney who closed the loan. So-called 'attorney's opinions' are still relied upon by smaller lenders in certain regions of the country, so long as the loan is not intended for sale in the secondary market.

Leading providers of title insurance in the U.S. include the following firms:
—Chicago Title Insurance Company
—Lawyers Title Insurance
—First American Title Insurance Company
—Stewart Title Guaranty Company
—Old Republic National Title Insurance Company

**Title Insurance and Loan Closing Agents Errors and Omissions (E&O) Insurance**. Unlike mortgage guaranty insurance, which is marketed and underwritten directly by the insurance company, the title insurance-mortgage lender marketing and underwriting relationship is handled by independent title insurance agents. These agents normally are local real estate attorneys or loan closing agents who perform all the title searches for the title company as well as loan closing services generally.

A special title insurance/loan closing agents errors and omissions policy has been designed for damages caused by negligent acts committed by agents for title insurance companies. This specialized professional liability coverage also includes legal defenses. This coverage extends to the loan closing process itself. Wrongful acts relating to the loan closing—e.g. documentation, disclosure, or funds disbursement--can undermine the integrity of the mortgage security such that mortgage guaranty insurance coverage could be jeopardized, or lender liability under consumer protection laws might be triggered.

While claims arising from mistaken opinions of title generally are excluded from coverage under the title insurance/closing agents E&O policy, title insurance companies themselves offer an ancillary title insurance product that covers title-related losses caused by the wrongful acts of title agents. Title insurance and loan closing agents' E&O coverage is not required by mortgage market investors, although it is often carried by 'escrow companies' which specialize in providing loan closing and related services for others.

**Mortgagees Errors and Omissions (E&O) Insurance and Mortgage Impairment Insurance**

Mortgagees errors and omissions coverage (an expanded form of which is also known as mortgage impairment insurance) is a specialized form of professional liability insurance which protects mortgage lenders and their secondary investors against certain liabilities and losses resulting from an error or accidental omission in the performance of certain customary operations. Mortgagee's E&O coverage typically includes the following components:

• *Mortgagee's interest* protects against property and casualty losses involving the borrower's home for which the insured lender/ servicer customarily requires its borrowers to maintain standard homeowners fire and extended coverage policies. Standard coverage excludes flood, earthquake and certain other perils, but mortgage impairment insurance may include a special flood insurance endorsement where such underlying coverage is required (see below).
• *Mortgagee's liability* covers the insured lender for legal damages that may arise from the insured lender's acting in the capacity as a mortgageholder, a mortgage fiduciary, or a mortgage servicing agent due to error or accidental omission in the operation of the insured's customary procedure in processing and maintaining valid liability insurance.
• *Property owned or held in trust* (optional) provides temporary coverage for loss or damage to property owned or held in trust by the insured lender—for example homes acquired through foreclosure—in the event that the loss is not otherwise insured due to an error or accidental omission by an employee of the insured.
• *Real estate tax liability* (optional) pays for damages for which the insured may become liable due to error or accidental omission in paying real estate taxes on behalf of the mortgagor.

E&O underwriting considerations relate mainly to the insured lender having in place and enforced appropriate written operating procedures for the handling of mortgages. Operating procedures must be periodically reviewed and audited to assure their appropriate content and ongoing compliance. Compliance should also involve substantive incentives and penalties for noncompliance.

The E&O policy form is not standardized among companies in the same sense that mortgage guaranty and title insurance forms are standardized. However, the general terms and conditions of different coverage components (see above) are quite consistent among companies that write E&O and mortgage impairment coverages.

Exclusions from E&O coverage generally are losses and damages arising from:
—personal injury
—libel and slander
—destruction or damage to tangible property
—war, civil disorder
—government action
—illegal discrimination (e.g. race, religion, age, etc.)
—court-awarded punitive damages
—breaches between affiliated entities
—breaches that would otherwise be covered under a fidelity bond (i.e. due to intentionally wrongful or criminal acts, rather than inadvertent error or omission)
—defective title or deed
—claimed or guaranteed economic value of a property
—pollution, earthquake, power failure or nuclear hazard
—failure of another insurance company to pay a valid claim
—failure to obtain title insurance
—wrongful action relating to securitized interests, rather than mortgage loans

Other typical provisions: The E&O policy normally may be canceled by either party, with notice to the other party. E&O policies normally provide for subrogation rights whereby the E&O insurer, upon paying a claim, acquires the full rights of the insured to seek recovery from responsible third parties. In contrast to mortgage guaranty or title insurance, the E&O (or mortgage impairment) policy itself is not assignable without the consent of the carrier, which consent would normally not be granted.

Errors and omissions coverage by originating lenders and mortgage servicers generally is required by the secondary mortgage market. E&O protection is a formal requirement of Fannie Mae and Freddie Mac, which also prescribe the minimum credentials of the acceptable E&O carrier and the minimum coverage requirements that must be maintained. The ‘base’ for determining minimum required coverage is the highest of the following three annual figures:
—total mortgage originations;
—total mortgage sales; or
—total mortgage volume serviced.

The amount of required coverage generally is based on a sliding scale against the lender’s ‘base’. Freddie Mac, for example, will purchase loans only from lenders that carry E&O coverage of at least $300,000 against their first $100 million ‘base’ plus additional coverage ranging from 0.10 to 0.15 percent of any base exceeding $100 million.

E&O coverage is purchased by the lender/servicer as a general cost of doing business. Whereas the lender/servicer is the insured under the E&O policy, the benefits are

assigned to the secondary market investor with respect to loans sold. Factors affecting the cost of E&O insurance include
—the number of mortgages covered
—aggregate coverage limits purchased
—amount of insurance deductible
—whether or not the perils covered include flood or earthquake insurance.

The only alternative to E&O (other than the equivalent terms provided by mortgage impairment insurance) is self-insurance. Leading providers of E&O or mortgage impairment insurance in the U.S. market include:
—Lloyd's of London
—American International Group (AIG)
—Chubb
—CIGNA
—American Bankers Insurance Group
—The Travelers Insurance Group
—National Union Fire Insurance Company

**Mortgage Bankers Bond**
**Financial Institution Fidelity Bond**

The mortgage bankers or financial institution fidelity bond (also known in expanded coverage form as a "blanket bond") is a form of surety that protects the mortgage lender/servicer against losses arising from the dishonest, fraudulent and criminal acts of its management and employees. It includes such actions, regardless of where they are committed or whether they are carried out in collusion with others outside the firm. The bond applies to losses that are discovered during its effective term, rather than to the point in time that the dishonest act(s) causing the loss actually occurred

The Surety Association of America has produced a standard financial institution fidelity bond form, but its terms are commonly modified to meet the needs of individual institutions. This form is not expressly designed for those whose primary business is mortgage banking.

The standard fidelity bond form covers losses from such specific acts or events as:
—employee dishonesty (acting along or in collusion with others)
—burglary or robbery
—misplacement, unexplainable or mysterious disappearance, damage or destruction
—forgery of checks or securities
—damage to equipment or furnishings as a result of vandalism, larceny or theft

Special optional coverage under the bond may be written for:
—extortion
—trading losses
—computer fraud
—servicing contractors
—loan participations
—counterfeit currency

The above coverages carried by a mortgage-related firm can extend to fraudulently defective documents such as mortgages, notes, deeds, liens, titles, guarantees, and security or escrow agreements, but the standard financial institution bond provisions may need to be tailored to fit such business requirements. Covered acts may include both direct employees and those acting as agent for the insured institution, although the definition of 'agent' may be set forth in some detail.

The following are typically excluded from coverage under a fidelity bond:
—of non-salaried, nonemployee directors
—losses from default on credit instruments
—expected, but unrealized income
—securities fraud
—losses evidenced only by an inventory or profit and loss computation
—trading losses
—losses that are covered under any other insurance policies
—losses resulting from the use of credit, debit, access, identification or other cards
—losses attributable to employee violation of securities law
—damage judgments arising from employee racketeering
—losses resulting from the dishonest act of a non-employee acting as a representative of the insured who is a securities, commodities, money, mortgage, real estate, loan, insurance, property management, or investment banking broker or agent
—fire
—war
—nuclear hazard

Other bond provisions include full subrogation rights for the bond issuer in the event of a claim. The bond may be canceled by either party, but by the issuer only with advance notice.

In the mortgage business, secondary market investors, including Fannie Mae and Freddie Mac require evidence of a fidelity bond from any seller or servicer with whom they do business. For example Freddie Mac stipulates the minimum rating credentials of the fidelity bond provider. As with E&O coverage, minimum required coverage is $300,000 for a 'base' of $100 million or less, with coverage on the excess over a $100 million base based on a sliding scale of 0.10 to 0.15 percent of the excess base amount, with a stipulated deductible allowed. (See E&O section above for definition of 'base'.) The required fidelity bond coverage must extend to persons authorized by the mortgage institution to perform legal services, process data, checks or accounting records.

In addition, the federal secondary market agencies require a separate fidelity insurance bond to be posted by a condominium (20 or more units) association's trustees, management and employees (including a property management company if applicable) if these persons handle funds held for the benefit of condominium owners.
The lender's fidelity bond is purchased by the mortgage institution as a general cost of doing business. As with E&O, while the benefits of the bond must be assigned to the secondary market investor, the bond itself would not be assigned.

Key factors affecting the cost of a fidelity bond are number of employees, locations covered, amount of coverage required and amount of deductible. A typical fidelity bond might cost about $5-10,000 per million of coverage, but could cost as little as $1,000 per million for a very high limit bond written for a superior institution.

There are many providers of financial institution fidelity bonds, including:

—Fidelity & Deposit
—AIG
—Chubb
—Aetna
—Reliance
—The Hartford
—Executive Risk
—The St. Paul Companies

**Mortgage Bankers Blanket Bond**. The U.S. mortgage banking industry, with the active participation of its national trade association, the Mortgage Bankers Association of America (MBA), has helped to develop a composite insurance product for its members called the Mortgage Bankers Blanket Bond. This blanket coverage includes a combination of protections commonly found in both the standard E&O or mortgage impairment policy together with those provided by the standard financial institution fidelity bond, with terms and conditions tailored specifically to the origination, pooling and sale of individual mortgages.

For example, the mortgage bankers blanket bond contains a specific E&O provision covering any failure by the servicer of a delinquent servicer to notify the mortgage guaranty insurer (see earlier section of this report) that an insured mortgage loan is in arrears or about to be foreclosed. Such failure to comply with a standard mortgage guaranty policy provision, if egregious, could result in a claim denial and loss of benefits for the servicer or its secondary investor.

Additional coverage limits may be secured by mortgage bankers whose business includes home construction lending in addition to loan origination and servicing. This type of blanket bond, including a standard product and form endorsed by the MBA, is routinely accepted by U.S. secondary market investors. Bankers Insurance Service Corporation, Chicago Illinois, provides a blanket bond to MBA members that is endorsed by that trade group. Other non-MBA endorsed blanket bonds provide similar protections.

**Mortgage Servicer Performance Bond.** The investment rating of a non-federally guaranteed mortgage-backed security, under which multiple servicers are responsible for loans comprising the mortgage pool, may be supported in part by a special surety called a mortgage servicer performance bond. Such a bond:
—covers losses due to improper servicing (similar to the mortgage bankers blanket bond)
—pays the cost of a servicing transfer to a backup servicer if the servicer defaults
—advances principal and interest, if not advanced by the servicer (cash flow guarantee).

The servicer purchases the bond, issued by a surety, and the trustee of the mortgage pool and mortgage-backed security is the named benefiary of the bond on behalf of institutional investors holding the security.

**Directors' and Officers' Liability Insurance (D&O)**

Directors' and officers' liability insurance is a form of professional liability insurance which can serve the needs of financial institutions, including those engaged in mortgage lending and the servicing of mortgage loans for third party investors. D&O coverage written for mortgage bankers may have special provisions especially applicable to this particular business.

D&O protects those engaged in home mortgage lending, selling and servicing against loss exposure arising from the wrongful (though not dishonest or criminal) acts of the business enterprise's executive managers and outside directors. The D&O policy covers damages, judgments and settlements. While legal defense costs may not be formally covered, the D&O carrier typically provides such assistance. There is no single standardized D&O policy form. D&O policy terms and conditions may vary according to a particular business's situation.

D&O coverage generally includes two facets: (1) protection of individual company officers and directors against loss exposure from wrongful acts carried out in the course of their service to the company; and (2) protection for the company itself from losses arising from the wrongful acts of their officers and directors in instances where the company itself has, in turn, indemnified the individuals involved against losses relating to the covered actions.

Exclusions from D&O coverage may vary among carriers and individual policies, but commonly include losses attributable to the following:
—losses covered by other valid insurance
—fines and penalties imposed by law
—punitive damages
—illegal acts for personal profit
—criminal or fraudulent acts by the insured
—failure to secure or maintain insurance
—pollution
—destruction or damage to tangible property
—bodily injury
—libel and slander
—acts performed while not in the service of the insured company

Other typical policy provisions: The D&O policy normally may be cancelled by either party, with notice to the other party. D&O policies normally provide for subrogation rights whereby the insurer, upon paying a claim, acquires the full rights of the insured to seek recovery from responsible third parties. In contrast to mortgage guaranty or title insurance, the D&O policy itself is not assignable without the consent of the carrier, which normally would not be given.

While D&O coverage typically is acquired by established institutions engaging in mortgage banking, unlike E&O and mortgagee fidelity bonds, D&O protection is not required by regulators or those secondary market investors who set standards for mortgage sellers and servicers, i.e. Fannie Mae and Freddie Mac. A firm's D&O requirements typically would originate with its outside directors.

Strictly speaking, D&O insurance protection does not run directly to loss exposure on individual mortgage loans. However, an individual mortgage banking firm's portfolio risk could be adversely affected, albeit indirectly, if the firm were to suffer debilitating uninsured losses due to wrongful acts by its executive officers. In the absence of D&O insurance protection, a financially distressed firm's secondary investors probably would invoke contract provisions authorizing the transfer of mortgage servicing to an alternative servicing agent.
D&O coverage is purchased by the lender/servicer as a general cost of doing business. The benefits run strictly to the covered firm and its own officers and directors. The concept of assigning the insurance policy or its benefits is not applicable to D&O.

Factors affecting the cost of D&O insurance include:
—the company's prior loss experience, if any;
—size of the organization, e.g. headcount, total assets, total revenues
—management experience
—ownership profile, i.e., publicly held, private, closely held
—amount of coverage required
—amount of deductible.

While there is no 'typical' cost range for D&O insurance, a minimum premium rate might be $10,000 per $1 million of coverage for a small institution. The only alternative form of protection is self-insurance.

Major providers of directors' and officers' liability insurance include:
—Chubb
—AIG
—CAN
—The St. Paul Companies
—Aetna Life and Casualty
—National Union Fire Insurance Company
—Reliance Insurance Group
—Homeowners Insurance (Fire and Extended Coverage)

Individual homeowners almost always carry their own homeowners property insurance policy which protects against loss by fire and, typically under 'extended coverage' provisions of the policy, a variety of other perils associated with homeownership. Extended coverage normally refers to theft, and personal liability and causes of physical damage other than fire.

Key underwriting considerations for homeowners insurance include the characteristics of the home as they affect fire risk, the type and quality on construction and region of the country as it affects replacement cost, the property location in terms of proximity to firefighting equipment and public water supply, the community rating for fire safety, special security devices installed and, of course, the amount of coverage and size of deductibles.

Homeowners policy forms are somewhat standardized, though not totally uniform. There are three general types of coverage forms:
1. "basic form": fire, lightning and internal explosion only, with options for extended coverage
2. "broad form" coverage. See below for coverage details.

3. special form “all risk” form. Not a “named peril” form, but covering instead all perils except a short list of exclusions such as acts by the insured, building code enforcement, and original construction flaws.

Broad form homeowners coverage, probably the most commonly used overall, and acceptable to mortgage lenders and investors, generally includes the following specific coverages:
—fire
—theft, burglary
—explosion
—lightning
—vandalism and malicious mischief
—rupture of heating systems, freezing pipes
—collapse, damage from falling objects, breaking glass
—weight of ice, snow, sleet
—other ancillary structures
—removal of debris
—personal property
—personal liability (e.g. for injuries suffered by persons while on the premises)
—repairs to protect damaged property from further damage
—loss of use of property/increased living expenses

Homeowners policy exclusions generally would include the following:
—losses having catastrophic potential, e.g. flood, earthquake and other earth movement, nuclear hazards, war
—land on which the covered building is located
—negotiable instruments/documents, currency, stored data
—motor vehicles on premises
—losses caused by neglect or irresponsible or intentional action of the insured

Home mortgage lenders and secondary market investors universally require: (a) that the homeowner’s property insurance coverage be sufficient to protect the full mortgage balance, and (b) that contains a standard mortgage clause which provides that the insurer notify the mortgagee at least ten days before any reduction in coverage or cancellation of the policy. The obvious purpose is for the lender to protect the value of the property securing the mortgage loan. Typically, a lender would require specific coverages such as are found in a standard broad form homeowners policy, as highlighted above.

The secondary market agencies, i.e. Fannie Mae and Freddie Mac, also impose detailed requirements upon their seller-servicers regarding the maintenance of homeowners insurance. These requirements include, in addition to minimum coverage and maximum deductible requirements, rating credentials (i.e. Standard & Poor’s or A.M. Best Company) for both direct insurers and reinsurers used. All insurance forms and correspondence must be with the servicer, not the borrower. In addition, in the event of a claim, Fannie Mae and Freddie Mac require their servicers to be closely engaged in the settlement and repair process to assure that claims proceeds are use to effect complete and timely restoration of the property.

Homeowners coverage is purchased directly by the borrower. The policy is issued in the borrower’s name, although the mortgage servicer may hold the policy and act as intermediary between homeowner and carrier in the handling of renewal premiums to be sure that coverage remains in force. While the policy itself would not be assigned to an investor, in the event of a total loss to the property, the claim proceeds would go to pay off the loan held by the investor.

Factors affecting the cost are essentially the same as those noted above relating to underwriting. Many policies automatically adjust for inflation, with premium adjustments made accordingly. Given the many variables and large regional variations, cost parameters are not very meaningful. Most typical homeowners policy premiums probably fall within a range of about $3 to $6 per $1,000 of coverage.

There are no alternative forms of protection for standard homeowners insurance. The only choices for the homeowner are which of the three standard forms of coverage to select and which among hundreds of providers to use.

**1. Catastrophic risk coverage**. If the homeowner's property is in a designated flood hazard area, the lender and secondary market investor are almost certainly going to require flood insurance protection (see below). The same may be true for other catastrophic risks such as earthquake, and even volcanic eruption or avalanche coverage that is not provided by standard homeowners policies. Earthquake and other special catastrophic risk coverages (excluding flood) are available as riders for an added premium on the standard homeowners policy forms.

**2. Condominium association coverage.** Closely related, and in addition to the hazards covered by standard homeowners insurance for individual homes is the type of property insurance that secondary investors require of condominium associations. Freddie Mac, for example, requires that condo associations wherein unit mortgages are held by Freddie Mac, maintain blanket "all risk" coverage for the full replacement cost of:
—all common elements within the condominium
—all fixtures, machinery, equipment and supplies
—fixtures, improvements, and equipment within the individual units

**3. Force-placed coverage**. While secondary market investors do not normally require so-called "force-placed" property coverage, many mortgage servicers still carry this ancillary coverage. Force-placed insurance may be imposed by the insurer upon any borrower who allows a policy to lapse, with the (considerably higher) cost paid by the lender and passed through to the borrower.

Among the leading providers of homeowners coverage in the U.S. are:
—State Farm
—Allstate
—Nationwide
—St. Paul
—Chubb
—AIG
—Royal
—USAA

**Lenders' REO insurance**. When a homeowner's mortgage goes into default and foreclosure, required coverage under that homeowner's inevitably will lapse, either for nonpayment of premium or because the standard homeowners policy does not cover vacant or abandoned properties. While force-placed insurance may provide temporary cover while the delinquent borrower still occupies the property, when the lender/servicer eventually takes title through foreclosure, another insurance requirement presents itself.

Although it is not a required form of coverge, most servicers carry a special blanket form of fire and extended coverage insurance to protect against loss on properties which they have acquired temporarily through foreclosure ("REO"). Because foreclosed homes are often vacant or abandoned, this coverage is offered by a limited number of carriers and tends to be quite costly, with high deductibles. Premium charges vary mainly with the size of the portfolio and are adjusted frequently as the number of properties in "REO" changes.

**Special hazard insurance.** Special hazard is a type of property and casualty insurance that may be used to support the credit rating of a private (i.e. not government supported) mortgage-backed security. Written against an entire pool of home mortgages underlying such a security, special hazard coverage protects against catastrophic losses from natural disasters, most notably earthquakes occurring in regions where: (1) earthquakes are a high risk; (2) pooled loans are highly concentrated; and (3) standard earthquake riders are not generally available.

**Flood Insurance**

Flood insurance is a specialized form of property and casualty insurance which in the U.S. involves a unique participation of the federal government in the underwriting and assumption of financial risk. The unusual degree of catastrophic risk and excessive concentrations of loss have resulted, for the sake of maintaining product availability, in the federal government's extensive involvement with flood insurance in the U.S., including subsidizing the cost to the homeowner.

Flood insurance for residential dwellings covers loss from damage or destruction of a home caused by temporarily rising waters, unusual and rapid runoff of surface water, or mudslides or collapse of waterfront land caused by abnormal waves or currents. Coverage can be extended for both the building itself and its contents.

Key underwriting considerations for flood insurance include, first of all, a determination by Federal Insurance Administration criteria that a particular residence is situated within a special flood hazard area (SFHA). In addition to the flood zone rating, the quality of a building's construction and materials are taken into account.

Private providers of flood insurance under the government program maintain detailed flood zone determination maps to rate flood insurance underwriting requirements. These special insurance providers, in turn, may carry their own special errors and omissions policy.

There is a standard flood insurance policy form promulgated by the Federal Insurance Administration. Separate versions apply to basic fire, extended coverage or "all risk" protection and also to single family homes versus condominium properties. These three defined scopes of coverage are comparable to those typically written under standard homeowners hazard insurance policies.

Coverage exclusions under the standard flood insurance policy include
—flood-associated losses caused by theft, fire, wind, explosion, earthquake or other land movement, or gradual erosion
—rain, snow, sleet, hail, ice, freezing, thawing, sewer backup
—water damage from causes within the building, i.e. linked to design, construction, structural or mechanical factors, including breakage/stoppage of water and sewer lines, drains and pumps
—modification of the property so as to increase the risk of flood damage
—power, heating or cooling system failure, unless directly caused by flooding

The flood insurance policy is noncelable by the insurer, except for nonpayment of premium. As noted above, flood insurance is required if the subject property is located in a special flood hazard area (SFHA) as a condition for securing a mortgage loan from a federally supervised mortgage lender. Secondary market agencies, including Fannie Mae and Freddie Mac, impose similar requirements. As with standard homeowners insurance, the secondary market agencies require flood insurance coverage for the greater of full mortgage balance or 80 percent of the full replacement cost of the home.

For properties located in designated flood hazard areas, the flood insurance coverage must be maintained for the full life of the loan. The policy is renewed annually. Unlike mortgage guaranty insurance, for which the premium charge is fixed for the life of the loan, annual flood insurance premiums may change as the home flood hazard rating changes.

**Condominium association coverage.** The secondary market agencies require that condominium associations must carry flood insurance, in addition to that which is required of their individual unit owners, equal to 100 percent of the value of common areas and all equipment and machinery.

**"Force-placed coverage"**. When flood insurance coverage has been allowed to lapse or is non-existent on a mortgaged property, the required coverage must be "force-placed" by the loan servicer. As with standard homeowners hazard insurance—also required by mortgage investors—the mortgage servicer purchases "force-placed" standard flood coverage and passes the premium charges through to the borrower.

Although the federal government assumes ultimate liability for flood insurance losses, nearly 100 private providers of flood insurance under a federally sponsored "write your own," or "WYO" delegated underwriting program, including:
—Mutual of Omaha
—State Farm
—Allstate

**Other Coverages**

Two other lines of insurance relating to home mortgage finance warrant at least a brief mention, namely: (1) mortgage redemption life and disability insurance, and (2) the mortgagor's completion bond. While commonly used, neither is routinely associated with the financing of individual homes in the United States.

**Mortgage redemption life and mortgage disability insurance.** The closely related life and health insurance lines, respectively, provide personal coverage for the home mortgage borrower in the event of his death or disability. Although mortgage life and disability coverage does offer some additional assurance of timely repayment in the event that the borrower—especially the family breadwinner—were to die or be disabled, neither of these coverages is required by either the direct lender or the secondary mortgage market. Rather, the ancillary marketing of these lines to new homeowners provides attractive agency commissions to many mortgage originators.

Mortgage redemption life insurance basically pays off the full outstanding balance of the mortgage loan if the covered borrower dies. Companion disability insurance (purchased less frequently than mortgage life), normally makes monthly mortgage payments for a stipulated maximum term in the event of borrower disability, i.e. inability to continue working.

A typical 30 year mortgage redemption life policy for a 25-year old male borrower might cost about $2.40 per $1,000 of coverage per year. The premium would decline with the mortgage balance. Insurance that will pay off the remaining mortgage balance in the event of the borrower's death is more commonly required as a condition for the mortgage lender granting the loan in countries other than the United States.

In the U.S. there has been experimentation, with little success, with a similar type of coverage which will make monthly mortgage payments for a maximum fixed period in the event of borrower unemployment.

**Mortgagor's completion bond.** The mortgagor's completion bond is a special form of surety. Large construction projects—but not the building of individual freestanding homes—often entail the posting of a completion bond by the building contractor for the benefit of the owner/developer. Such projects--including large multifamily buildings whose units will sell as individual condominium dwellings--also may call for a comparable mortgagor's completion bond, whereby the owner, who is also the mortgage borrower, is required by the lender to post a bond guaranteeing that the property that is being pledge to secure a large construction loan will, in fact be completed to provide the full security required.