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THE PRIVATE MORTGAGE INSURANCE INDUSTRY, THE THRIFT INDUSTRY AND THE SECONDARY MORTGAGE MARKET: THEIR INTERRELATIONSHIPS

DIANA G. BROWNE*

I. INTRODUCTION

THE CONCEPT of private mortgage insurance is a simple one. At the time a mortgage loan is made, the lender requires, as a condition to making a loan with a high loan to value ratio, that the borrower purchase private mortgage insurance on a portion of the loan, generally the top 20 to 25%. While the premiums are paid by the borrower, either at the time the loan is made or over the early life of the loan, the insured is not the borrower but the lender which, under the terms of the insurance contract, will be indemnified for losses incurred by virtue of the borrower's default.

Thus, the private mortgage insurance contract is similar to a suretyship agreement: if the party who is primarily responsible for the performance of an obligation (the borrower) fails to perform that obligation (to repay the mortgage loan) the party who has become secondarily liable for performance (the mortgage insurer) will perform the obligation. However, mortgage insurance differs from the standard suretyship agreement in one important respect. The insurer is not subrogated to the rights of the lender. Under the standard mortgage insurance master policy, a mortgage insurer generally has the option in the event of default and foreclosure either to pay the lender the contractually agreed upon 20 to 25% and permit the lender to retain the property, or to pay the lender the entire mortgage amount and to take title to the property. Whichever option is exercised by the insurer, the insurer's rights are limited to rights against the property and the borrower has no further liability.

While the direct beneficiary of mortgage insurance is the lender, there are indirect but substantial benefits to the borrower. The availability of insurance coverage to insure payment on the top portion of high ratio loans has made lenders more willing to make such high ratio loans. As

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a result, borrowers are able to obtain conventional mortgage loans for up to 95% of the appraised value of the homes, which in turn enables those borrowers to purchase better homes (or at least larger or more expensive homes) in return for smaller initial investments.

The concept of private mortgage insurance is not new, although the modern era in the industry did not begin until 1957. Insurance companies, most of which were chartered and operated under the laws of New York, began guaranteeing repayment of mortgage loans in the late nineteenth century. That industry continued to expand until it collapsed in the early 1930s as a result of the combined forces of the Depression and questionable practices in the industry itself. For the next twenty-five years mortgage insurance was provided by the government, primarily by the Federal Housing Administration (FHA) beginning in 1934. In addition, loans were guaranteed by the Veterans Administration (VA) beginning in 1944. The era of private mortgage insurance as it exists today began in 1957 when Mortgage Guaranty Insurance Corporation (MGIC) was chartered under the laws of Wisconsin.

The private mortgage insurance industry has experienced tremendous growth since 1957 in terms of the number of companies doing business as well as the volume of business handled, both absolutely and in relation to government insurance programs. This absolute and proportional growth is primarily attributable to three factors: the inherent advantages of private mortgage insurance over government mortgage insurance; federal regulations permitting lenders to make higher ratio loans if such loans are covered by private mortgage insurance; and the expansion of the secondary market in conventional mortgages, particularly the federal public secondary market in which coverage by private mortgage insurance is a prerequisite to the purchase of high ratio loans.¹

On the other hand, the existence of the private mortgage insurance industry has facilitated the expansion of the thrift industry and of the secondary mortgage market. Twenty-two years after the formation of the first modern private mortgage insurance company and nine years after the creation of the federally sponsored market in conventional mortgage loans, the growth and success of the three industries can be seen as significantly interrelated.

¹ Pursuant to statute, coverage by private mortgage insurance is only one of three alternative prerequisites to the purchase of high ratio loans. However, as a policy matter, private mortgage insurance is required on such loans as a prerequisite to purchase. See discussion in Section III C, *infra*.

II. HISTORY OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY

A. *Pre-Depression*

The first era in the private mortgage insurance industry began in the late nineteenth century as an outgrowth of the title insurance industry and reached its height in the early 1930s, immediately before it collapsed entirely. The mortgage guaranty industry was concentrated almost entirely in New York and was regulated, to the extent that it was regulated at all, under the laws of New York. In order to understand today's concerns with regard to the structure and practices of the private mortgage insurance industry, it is necessary to study the evolution of the early private mortgage guaranty industry, its structure and practices. A 1974 article dealing with regulation of private mortgage insurance states that "the operations during that [pre-depression] era led to the historical image of an industry filled with financial malpractice, chicanery, manipulation of the small investor, and disaster in a largely unregulated environment."² After the collapse of the mortgage guaranty industry, New York Governor Herbert H. Lehman ordered an investigation both of the State Insurance Department's activities with regard to the title insurance and mortgage guaranty companies, and of the companies themselves. The Governor also requested recommendations for legislation which would provide adequate supervision of the industry by the State Insurance Department. This investigation resulted in an exhaustive report on the growth of the mortgage guaranty industry, the practices of the industry and the problems caused by those practices. The report ended with a series of recommendations for the prevention of the recurrence of similar problems.³ This report, commonly known as the Alger Report, has been characterized as the "cornerstone of all regulation" of the mortgage insurance industry.⁴

The mortgage insurance industry in New York grew out of an 1885 statute authorizing title insurance. This statute was broadly interpreted by title insurance companies to permit guarantee not only of title but of payment by the mortgagor as well. This interpretation was adopted by the New York legislature in 1904 through an amendment to the Insurance Law which permitted title companies to guarantee payment of bonds and mortgages against loss incurred by reason of defective title or other incumbrances. Companies were required to maintain a guaranty fund equal

² Johnson and Flanigan, *Regulation of Private Mortgage Insurance*, C.P.C.U. Annals 92 (June 1974).

³ *Report to His Excellency Herbert H. Lehman, Governor of the State of New York*, by George W. Alger, Moreland Comm'r (October 5, 1934).

⁴ Graaskamp, *Development and Structure of Mortgage Loan Guaranty Insurance in the United States*, J. of Risk and Ins. 48 (March 1967).

to two-thirds of their original capital stock. There was no limit on outstanding guarantees in relationship to capital, but if the guaranty fund was impaired, the company could write no more insurance until it became "unimpaired." Companies were permitted to invest the guaranty fund in mortgages.

In 1911, the Insurance Law was amended to permit the companies to invest in, purchase and sell bonds and mortgages which were lawful investments for insurance companies, with guarantee of payment or guarantee of title alone. This authority was expanded in 1913 to permit the guarantee of individual or partnership notes which were secured by mortgages or deed of trust upon real property, provided that such instruments were on real property worth 50% more than the amount loaned thereon.

The protective features of the legislation adopted in 1904 with regard to the guaranty fund were weakened in 1929 as the law then no longer required that a separate guaranty fund be maintained. Instead, the requirement was only that two-thirds of the company's paid-in capital be invested in "minimum capital investments," defined as federal, state, city or county obligations, or bonds and mortgages. The company merely had to hold these investments among their assets; they were not required to be segregated.

In short, each amendment to the State Insurance Law increased the authority of the title insurance and mortgage guaranty companies, and each attempt to limit those companies' powers was defeated in the legislature. This progressive liberalization of the Insurance Law has been attributed to control by the industry,⁵ which control was partially a result of public confidence in the companies. The companies' officers and directors were well respected in their communities, and real estate was perceived as a sound investment. This latter assumption had been existent for many years: in an economy where real estate prices had continued to rise and foreclosed property could be sold at a profit, the companies had been able to operate for many years without a loss. There was little oversight of the mortgage guaranty companies' operations. The review that did exist was performed by the State Insurance Department which had limited jurisdiction and was not staffed adequately to successfully carry out even its assigned functions.

Although their business involved guaranteeing the payment of mortgage loans, the mortgage guaranty companies of the early twentieth century

⁵ "One can reasonably deduce that the evolution of legislation granting authority for mortgage guarantee activity was controlled largely by the companies involved in the business." Johnson and Flanigan, *supra* note 2 at 93.

functioned substantially differently from the present mortgage insurance industry. Today's mortgage insurance companies issue insurance commitments to protect the lender against loss resulting from nonpayment by the borrower. In return for providing this protection, the insurer receives premiums paid by the borrower. The insurer never owns the mortgage or any interest in the mortgage. If the lender sells the mortgage in whole or in part to any investor, the mortgage insurance remains in force to protect the investor as well. However, the sale of the mortgage is essentially irrelevant to the insurer: the insurer does not participate in the sale and its interests are not affected thereby. In contrast, the old mortgage guaranty companies purchased mortgages from originators. The companies then sold the mortgages to investors, either as individual mortgages or as certificates representing an interest of a particular dollar amount in a pool of mortgages, with a guarantee of principal and interest payment. The guarantee was given subsequent to the origination of the loan, and obtaining the guarantee was not a condition to the loan's being made. The borrower did not pay a premium. Instead, the mortgage guaranty companies made their profits from the sale of the mortgages themselves and from the guarantee fees paid by the investor. This operation is more closely analogous to today's secondary mortgage market than to today's private mortgage insurance industry.

The Alger Report also dealt in detail with the structure of the mortgage guaranty companies and the problems created thereby. Many problems were created by the use of holding companies, particularly the affiliations between mortgage guaranty companies and banks. Common ownership of stock, ownership of each other's stock, common officers and directors, joint mortgage committees and joint appraisal departments were widespread practices. When banks and mortgage guaranty companies were thus affiliated, problems existed whether the mortgage guaranty company was the subsidiary or the parent. When the bank was the parent, the investing public was given the impression (often with the aid of deceptive advertising) that the guarantee on the certificates sold by the mortgage guaranty company constituted a guarantee by the bank. When the bank was the subsidiary, it was often forced into unsound banking practices for the benefit of the mortgage guaranty company. Subsidiary banks were frequently pressured into making questionable loans so that the mortgage guaranty company could then sell the loans. The mortgage guaranty companies had no fear of loss in these transactions; even if they had to pay off on their guarantee, the foreclosed properties could generally be sold at a profit. Further, the parent mortgage guaranty companies could require their subsidiary banks to deposit funds in a manner which would benefit the parent company. The Alger Report cited an example in which a

mortgage guaranty company required its subsidiary bank to deposit its funds in a large bank in order to induce the large bank to make a loan to another subsidiary of the mortgage guaranty company.

The problems of deception and self-dealing through subsidiaries were not limited to cases in which the affiliates were banking institutions. In the nonbanking context, a major problem was the use of subsidiaries to hold title to foreclosed property. This foreclosed real estate owned by the subsidiary would appear on the mortgage guaranty company's balance sheet as "stocks owned" in the amount of the foreclosed mortgage plus interest, foreclosure costs and expenses. Thus a false impression of the mortgage guaranty company's financial strength was given. In addition, these subsidiaries were used as a mechanism whereby new mortgages on the property could be originated and sold to investors. The subsidiary became the mortgagor on the property, and the parent mortgage guaranty became the mortgagee. The mortgage guaranty company then guaranteed and sold the mortgage. The investing public had no means of knowing that the original mortgage had been foreclosed or that the mortgagor whose obligation the mortgage guaranty company was guaranteeing was in fact that company's subsidiary. Because the State Insurance Department had no jurisdiction to investigate the subsidiaries of mortgage guaranty companies, the questionable practices carried out through the subsidiaries were hidden from public view.

The selling of foreclosed mortgages was also facilitated by the typical payment provisions in the mortgage certificates. Under the terms of the certificate, the mortgage guaranty company made interest payments to the investor throughout the life of the mortgage loan, but was not required to make principal payments until eighteen months after the loan was due. Most certificates gave the mortgage guaranty company the further right to substitute mortgages in the portfolio which backed the certificates. Thus, sound mortgages which could be sold individually to sophisticated investors were removed from the portfolio and replaced with mortgages already in default. When real estate values began to fall in 1931, the eighteen month clause was frequently invoked. However, the mortgage guaranty companies continued to advertise mortgages and mortgage certificates as sound investments and sold them until the Bank Holiday on March 4, 1933.

Between the Bank Holiday and August 3, 1933, nearly all of the mortgage guaranty companies were taken over by the state. When the state took over forty-seven companies (fifty had existed at the height of the industry in 1931) it was discovered that in the aggregate they had

\$184,000,000 in capital and surplus to secure \$1,700,000,000 in mortgage and real estate securities.⁶

The Alger Report contained a number of recommendations for legislation to prevent a recurrence of the disaster that had befallen the mortgage guaranty industry. These recommendations included: annual examinations by the government, supervision of appraisal, limitations on the guarantee amount with regard to a particular mortgage vis-a-vis the appraised value of the property, limitations on the total guarantees a company had outstanding in relation to the company's capital and surplus, limitations on ownership of other companies by mortgage guaranty companies and ownership of mortgage guaranty companies by other entities, and penal provisions in the conflict of interest area. However, rather than adopting these recommendations, the New York State legislature outlawed mortgage guaranty insurance entirely in 1938. Because most of the mortgage guaranty business had been concentrated in New York, the industry nearly ceased to exist.⁷

B. *Government Insurance*

The involvement of the federal government in the mortgage insurance area began when Congress enacted the National Housing Act of 1934, authorizing the Federal Housing Administration (FHA) to insure home mortgage insurance loans.⁸ The FHA program⁹ has been described as the first attempt to apply insurance principles to mortgage insurance, and the creation of the FHA as the factor that eventually made possible the reconsideration of private mortgage insurance in 1957.¹⁰

Nevertheless, there were a number of problems with FHA insurance which prevented its total acceptance by lending institutions, particularly savings and loan lenders. Certain FHA practices were regarded by lenders as substantial federal government interference with their lending practices. Among the practices regarded by the lenders as most objectionable were the settings of detailed standards to which FHA approved mortgages were required to adhere and the performance by FHA of appraisal and underwriting functions for individual loans prior to insuring them which resulted in substantial delays in making loans. The savings and loan industry was

⁶ Graaskamp, *supra* note 4 at 50.

⁷ Johnson and Flanigan, *supra* note 2 at 95.

⁸ 12 U.S.C. § 1709 (1964).

⁹ A more limited government mortgage guaranty program was enacted as part of the Servicemen's Readjustment Act, ch. 268, 58 Stat. 291 (1944), *as amended* 38 U.S.C. § 1810 (1964), whereby the Veterans Administration was authorized to guarantee loans made to veterans.

¹⁰ Graaskamp, *supra* note 4 at 52-53.

also uncomfortable with the hidden charges of the points system which had resulted from the below market interest ceilings on FHA loans. Finally, FHA insurance was expensive to the borrower: the insurance premium was not only high (one-half of one percent) but was also required to be paid throughout the life of the loan.¹¹

An attempt was made by the savings and loan industry to create a government insurance program which would avoid the problems it perceived to exist with FHA. In 1958, the United States League of Savings Associations secured the introduction of legislation, for inclusion in the Housing Act of 1958, which would have created a subsidiary of the Federal Home Loan Bank Board (FHLBB) to provide home mortgage insurance. Unlike FHA insurance, the proposed FHLBB subsidiary would have insured only the top 20% of each loan, and only for the first ten years; it would have relied upon the appraisal and underwriting performed by the lender subject to spotchecks by the insurer; and there would have been no interest ceilings. However, banking interests secured amendments which would have incorporated into the legislation a number of the features of FHA insurance which the savings and loan industry found objectionable. The savings and loan industry therefore disclaimed the bill, and it was subsequently defeated.¹²

C. *The Modern Era of Private Mortgage Insurance*

Although legislation that would have provided federal insurance without FHA's problems failed to be enacted, the discussions of the concepts of partial insurance and reliance upon the lenders' underwriting that had taken place prior to the introduction of that proposed legislation had resulted in acceptance of those concepts by the savings and loan industry. While the opposition to FHA grew, the need for high ratio loans also became apparent. These factors, in addition to more subtle ones such as the confidence in big business as opposed to big government which was prevalent during that era, resulted in receptivity to the concept of private mortgage insurance, notwithstanding the pre-Depression experience.¹³ Thus, the modern era of private mortgage insurance began in 1957 with the chartering of Mortgage Guaranty Insurance Corporation (MGIC) under the laws of Wisconsin. Since that time, numerous states have authorized the chartering of private mortgage insurance companies, and the number of companies has continued to grow. At present there are twenty mortgage

¹¹ *Id.*

¹² *Id.* at 54.

¹³ *Id.*

insurance companies which have been deemed qualified by the Federal Home Loan Mortgage Corporation.¹⁴

Since the founding of MGIC in 1957, the private mortgage industry has experienced tremendous growth, both absolutely and in the share of the mortgage insurance market occupied by private mortgage insurance as opposed to government mortgage insurance. Between 1960 and 1977 the amount of private mortgage insurance in force grew from \$0.3 billion to \$63.0 billion, while the combined amount of the FHA and VA insurance increased from \$56.4 billion to \$141.6 billion.¹⁵ The percentage of total outstanding mortgage debt on one to four family nonfarm homes which are privately insured was 30.8% in 1977, compared with .5% in 1960.¹⁶ Most of the mortgages covered by private mortgage insurance are originated by savings and loan associations. At the end of 1978 65.5% of all mortgages covered by private mortgage insurance were originated by savings and loan associations, as compared with 20.7% by mortgage bankers, 8.1% by commercial banks, 5.0% by mutual savings banks and 1.0% by credit unions and others.¹⁷

III. OPERATION OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY

A. *Standardization of Operations and Practices*

Although there are now a substantial number of private mortgage insurance companies, the industry's operations and practices are highly standardized. This standardization is due primarily to the following factors. First, most of the major insurance companies belong to the mortgage insurers' trade association, Mortgage Insurance Companies of America (MICA), which publishes Operating Guidelines codifying procedural and underwriting practices and criteria prevalent in the mortgage insurance industry to which the members are encouraged to adhere. Second, the eligibility requirements imposed by the Federal National Mortgage Association (FNMA) and FHLMC, as discussed below, have contributed to standardization. A third factor has been the success of MGIC and its initial dominant market position which enabled Wisconsin's legislation permitting private mortgage insurance to become a model for other states and MGIC to become a model for other insurers. As a result of these factors, there are few variations among companies with regard to master policy terms, underwriting standards and premiums.

¹⁴ See discussion in Section IV, *infra*.

¹⁵ *Economic Report of the President* 335 (January 1978); *MICA Fact Book and Directory*, Mortgage Insurance Companies of America, at 8 (1978-1979).

¹⁶ *Id.*

¹⁷ *MICA Fact Book*, Mortgage Insurance Companies of America, *supra* note 15 at 5.

The major underwriting effort takes place prior to the mortgage insurer's issuance of a master policy to the lender. Each lending institution seeking status as an insured lender is required to submit an application for a master policy, along with certain other documentation. Most mortgage insurers require information on the lender's current financial status as contained in its audited financial statements, the qualifications of the lenders' appraisers, the size and composition of its residential loan portfolio, the volume of residential loan business done in the past, its methods of servicing delinquent loans, and its regulatory status.¹⁸ The 1975 study of the mortgage insurance industry submitted by Arthur D. Little, Inc. to FNMA and FHLMC found that these requirements are typically applied more stringently to lenders that are not regulated by federal or state government.¹⁹ If the mortgage insurer determines that the lender meets the eligibility criteria contained in its lender qualification procedures, a master policy is then issued which entitles the lender to submit individual loans for insurance.

The mortgage insurer determines the lender's continuing eligibility by reviewing the lender's regular performance report and by spot checks of the lender's appraisal program and of credit reports submitted by the lender in connection with individual applications for insurance.²⁰ In the event that an insured lender's performance is inadequate, the mortgage insurer may increase the care with which it underwrites loans submitted by that lender, engage in lender education or ultimately cancel the lender's master policy. This last option has no effect upon insurance already in force.

Once the master policy is in force, the insured lender may submit applications for insurance on individual loans, along with information concerning the property and the borrower.²¹ However, the insurer relies heavily upon the underwriting already performed by the lender which makes the process of insuring individual loans a rapid one. According to the Arthur D. Little study, the surveyed mortgage insurance companies accepted or rejected 60% to 90% of all loans submitted within one business day.²² This very rapid service is in notable contrast with the thirty to forty-five day lags that are not uncommon with FHA and VA, and is an important factor in explaining lender preference for private mortgage insurance.

¹⁸ *Operating Guidelines*, Mortgage Insurance Companies of America, § 2.02 (July 1, 1978) (hereinafter referred to as *Operating Guidelines*).

¹⁹ *The Private Mortgage Insurance Industry - Report to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation* Arthur D. Little, Inc., at 17 (April 1975) (hereinafter referred to as A. D. Little, Inc. Report).

²⁰ *Operating Guidelines*, at § 2.03.

²¹ *Id.* at §§ 3.10-.05.

²² A. D. Little, Inc., Report *supra* note 19 at 22.

The costs of insurance are also standardized. Typically, one-half of one percent of the loan amount is paid initially and one-fourth of one percent annually for ten years. In return for this premium the top 20 or 25% of the loan, depending upon the policy, is insured.

B. Competition within the Private Mortgage Insurance Industry

Because the product and price are virtually identical, competition within the industry tends to focus upon other aspects of the business. Some elements of the competition are harmless or even beneficial to the lender and the insurer, such as rapid issuance of commitments upon submission of loans by the lender, personal contacts between the insurer and the lender, and secondary market services offered by the mortgage insurer to the lender. However, another means of competing which is detrimental to mortgage insurance companies and ultimately to the mortgage industry is the lowering of the underwriting standards by the mortgage insurance companies. This practice is frequently justified as necessary to the insurance industry because the loans rejected by one insurance company will be insured by another company, while the first company which attempted to uphold higher underwriting standards will not succeed in doing so, but will merely lose the business. This tendency toward the lowest common denominator is sometimes referred to as "post office box underwriting."

An additional practice widely acknowledged in the mortgage insurance industry is the maintenance of compensating balances in lending institutions in return for the institutions insuring loans with the mortgage insurance company. Not only is this admitted, but a close correlation has been found between assets so invested by a mortgage insurance company in any one state and the volume of premiums written in that state.²³ This practice also results in a lowering of underwriting standards because the resulting tie between the lender and the insurer creates a situation where the insurer is inclined to insure loans submitted by the lender without due regard for their quality.

C. Competition with Government Insurance and Self-Insurance — The Effect of Governmental Requirements

There is another aspect of competition in the mortgage insurance industry besides competition among the private mortgage insurance companies. The private mortgage insurance industry as a whole competes with government insurance and self-insurance. The competitive advantages held by the private mortgage insurance industry over government insurance (FHA and VA), such as lower premiums, more rapid issuance of insurance commitments, and market interest rates, are outlined above. Statistics

²³ *Id.* at 124.

clearly show that the private mortgage insurance industry has steadily gained ground in this competition. The other major source of competition is self-insurance by the lender; the lender determines to bear the risk of loss itself. Self-insurance by lenders is disadvantageous to the mortgage insurance industry not only because the mortgage insurers lose the premiums which would otherwise be paid by lenders, but also because of the adverse selection problem. Lenders which prefer self-insurance do not generally self-insure all loans, but only those they perceive to be of higher quality. A pattern results whereby weaker loans tend to be submitted to the mortgage insurance companies. However, at the same time government insurance creates competition for the private mortgage insurance industry, federal statutes and regulations promulgated by the Federal Home Loan Bank Board assist the private mortgage insurance industry in its competition with self-insurance, by facilitating through statutes or regulations the making of higher ratio loans when the top portion is covered by private mortgage insurance.

The Emergency Home Finance Act of 1970²⁴ has also had substantial impact upon the private mortgage insurance industry. Title II of that Act amended the Federal National Mortgage Association's charter²⁵ (FNMA) to authorize FNMA to provide a secondary market for conventional mortgages. While FNMA had previously been limited to the purchase and sale of government insured mortgage loans (FHA and VA), Title II amended FNMA's charter to permit purchase and sale of conventional mortgages. Title II, however, further provided that no conventional mortgage could be purchased if the outstanding principal balance of the mortgage at the time of purchase exceeded 75% of the value of the property securing the mortgage unless: (A) the seller retained a participation interest of not less than 10% in the mortgage; (B) the seller agreed to repurchase or replace the mortgage upon demand of the corporation in the event that the mortgage was in default; or (C) that portion of the unpaid principal balance of the mortgage which was in excess of 75% was guaranteed or insured by a qualified private insurer as determined by FNMA.²⁶ This section was amended in 1974 to impose these limitations when the loan to value ratio exceeded 80% rather than 75%, and to require when the insurance option was taken that the unpaid balance of the loan in excess of 80% rather than 75% be covered by insurance.²⁷

Title III of the Emergency Home Finance Act of 1970, known as

²⁴ Pub. L. 91-351, 84 Stat. 450 (1970) (codified at 12 U.S.C. §§ 1717, 1454).

²⁵ 12 U.S.C. § 1717 (1979).

²⁶ *Id.*

²⁷ *Id.*

the Federal Home Loan Mortgage Corporation Act, created the Federal Home Loan Mortgage Corporation. Title III contained a provision which was virtually identical to Title II's provision with regard to FNMA. FHLMC was prohibited from purchasing a conventional mortgage if the outstanding principal balance of the mortgage at the time of purchase exceeded 75% of the value of the property securing the mortgages unless: (A) the seller retained a participation interest of not less than ten percent in the mortgage; (B) the seller agreed to repurchase or replace the mortgage upon demand of the corporation in the event that the mortgage was in default; or (C) that portion of the unpaid principal balance of the mortgage which was in excess of 75% was guaranteed or insured by a qualified private insurer as determined by FHLMC.²⁸ This section was also amended in 1974 to impose these limitations only when the loan to value ratio exceeded 80% rather than 75%, and to require when the insurance option was taken that the unpaid principal balance of the loan in excess of 80% rather than 75% be covered by insurance.²⁹

While the statute permitted two alternatives to mortgage insurance when a loan exceeds 80% of value, FHLMC has adopted more stringent requirements for its own protection when purchasing a loan which exceeds that percentage. FHLMC's "Sellers' Guide — Conventional Mortgages" sets forth requirements for all conventional loans purchased by FHLMC and constitutes part of the contract with regard to each loan purchased. The Sellers' Guide requires mortgage insurance issued by an FHLMC approved mortgage insurer on all mortgage loans that have a loan to value ratio in excess of 80%.³⁰ Coverage is required on the amount in excess of 75% of value, and must remain in force until the mortgage loan is reduced to 80% of the original value, at which time it may be cancelled. Although FHLMC purchases participation interests in which the loan's seller retains a participation interest of 10% or more, this retained interest by the seller does not constitute a substitute for mortgage insurance under FHLMC requirements, notwithstanding the provisions of § 1454 (a) (2) (C).³¹ It is not feasible for FHLMC to adopt the option set forth in § 1454 (a) (2) (B) of the statute whereby the seller of a loan in excess of 80% agrees to repurchase the loan in the event of default.³² Federal Home Loan Bank Board (FHLBB) Insurance Regulations prohibit federally insured savings and loan associations from selling loans or

²⁸ 12 U.S.C. § 1454(a)(2) (1970).

²⁹ *Id.*

³⁰ Sellers' Guide — Conventional Mortgages, Federal Home Loan Mortgage Corp., § 3.201(c).

³¹ 12 U.S.C. § 1454(a)(2)(c) (1979).

interests in loans with recourse.³³ A requirement of repurchase by the seller upon default would constitute a with recourse transaction pursuant to the definition contained in the regulations.³⁴ Because a substantial portion of sellers of loans to FHLMC would thus be prohibited from exercising this option, FHLMC has not considered adopting this alternative administratively.

Both governmentally chartered corporations providing a secondary market for conventional mortgage loans are authorized to establish standards for the qualifications of the mortgage insurers which insure the top risk portion of high ratio loans, and both corporations have done so. However, the private mortgage insurance industry is relatively more important to FHLMC than to FNMA; a far higher percentage of the loans purchased by FNMA are government insured than is the case for FHLMC. FHLMC was created a part of the Federal Home Loan Bank system³⁵ and was authorized to deal only with federally insured depository institutions. FHLMC has therefore tended to focus its purchase programs on the types of loans originated by the savings and loan associations and other depositing institutions. These institutions originate very few government insured loans. FNMA, in contrast, has dealt mainly with mortgage bankers which are not depository institutions and which have originated mainly FHA/VA loans. Recent statutory and economic developments (which are beyond the scope of this article) have altered FHLMC's seller base and the percentage of FHA/VA loans delivered to FNMA. These developments will probably tend to make private mortgage insurance as important to FNMA as it is to FHLMC.

Federal regulations as well as federal statutes have contributed to the growth of the mortgage insurance industry. Since 1971, FHLBB regulations applicable to federally chartered savings and loan associations have permitted such institutions to make home mortgage loans of up to 95% of the value of the security property provided that either: (1) "the association establishes and maintains a specific reserve with respect to such loan equal to one percent of the unpaid principal balance until the unpaid principal balance has been reduced to an amount not in excess of 90% of the value or purchase price of the real estate security, whichever is

³² *Id.* at § 1454(a)(2)(b).

³³ 12 C.F.R. § 563.23 (1978).

³⁴ *Id.* at § 561.8.

³⁵ Pursuant to the FHLMC Act, FHLMC is under the direction of a Board of Directors composed of the members of the FHLBB, and the Chairman of the FHLBB is the Chairman of FHLMC. FHLMC is a member of each Federal Home Loan Bank. The capital stock of the Corporation consists of non-voting common stock, which is issued only to Federal Home Loan Banks, 12 U.S.C. § 1454 (1979).

less, determined at the time the loan was made;"³⁶ or (2) that as long as the unpaid balance of the loan is in excess of 90% of the value or purchase price of the real estate security, the amount which is in excess of an amount equal to 80% of the value or purchase price of the real estate security is guaranteed or insured by a mortgage insurance company which has been determined to be a qualified private insurer by FHLMC.³⁷ The same requirements were established for federally insured associations in 1974.³⁸ The specific reserve requirement is extremely expensive to the lender. Therefore, on nearly all loans in excess of 90% of value made by savings and loan associations that are either federally chartered or federally insured, the borrower is required to obtain private mortgage insurance written by a mortgage insurer approved by FHLMC pursuant to the eligibility requirements set forth below, as a condition to the lender's granting the loan.

IV. INTERRELATIONSHIP BETWEEN THE FEDERAL SECONDARY MARKET AND THE PRIVATE MORTGAGE INSURANCE INDUSTRY

A. *FNMA and FHLMC Eligibility Requirements for Mortgage Insurers in General*

FNMA and FHLMC, have been authorized by Congress to purchase high ratio conventional loans insured by private mortgage insurers they deem to be qualified, proceeded to establish standard as to what constitutes a qualified insurer. While the area was a new one for federal involvement, a number of states had established statutory and regulatory requirements applicable to the mortgage insurance industry which were aimed at avoiding the problems that had caused the demise of the mortgage guaranty industry in the 1930's. FNMA and FHLMC requirements were initially based upon those contained in the various state laws. However, the corporations' requirements were more stringent and comprehensive than state laws in such areas as minimum capital, geographic diversity of risk, and right to control and review of mortgage underwriting practices. Subsequent amendments exceed state requirements even further, reflecting developments in and experience with the mortgage insurance industry.

There are two basic concerns addressed through requirements placed upon mortgage insurers: (1) to ensure quality underwriting to diminish the likelihood that the loan will go into default and the insurer will be required to pay a claim; and (2) to ensure the financial solidity of the insurer so that if the insured loan does go into default, the insurer has

³⁶ 12 C.F.R. § 545.6 1(a)(5)(v)(b) (1978).

³⁷ *Id.* at 1(a)(5)(v)(a).

³⁸ *Id.* at § 563.9 7(a).

the resources to pay the claim. State requirements are primarily financial while the initial FNMA and FHLMC requirements were primarily aimed at ensuring the financial solidity of the insurer. FNMA requirements have remained primarily financial, while FHLMC's requirements have been altered over time to address the underwriting concern as well.

FNMA's requirements are contained in the application for approval itself, a four page form entitled "Request for Determination of Qualification of Private Mortgage Insurer." The standards are written primarily in terms of guidelines and suggestions rather than absolute requirements or prohibitions. The preface states that determinations as to whether applicants are qualified mortgage insurers will be individually made,³⁹ and the bulk of the guidelines consists of a listing of the considerations used in making that determination. Mortgage insurers which have a meaningful business history and substantial experience are expected to have a policyholders' surplus (capital plus surplus plus contingency reserve) of not less than \$2,000,000 at the time the application is submitted which will be increased within a reasonable period of time to \$5,000,000. Those without such history and experience are expected to meet the \$5,000,000 requirement at the time the application is submitted.⁴⁰ The relationship between the total liability of the mortgage insurer under all policies and the policyholders' surplus is considered by FNMA, and generally should not exceed a twenty-five to one ratio.⁴¹ The mortgage insurer's general financial solidity is also determined from audited financial statements, annual reports to stockholders, and similar sources, which are also required to be submitted with the application for approval by FNMA.⁴²

While the emphasis of the FNMA requirements is upon the financial strength of the mortgage insurer, there are also certain requirements or guidelines in the area of general business practices and underwriting practices. In order to obtain approval by FNMA, the mortgage insurer must be licensed to do business in at least one state.⁴³ It is preferred, although not absolutely required, that the principal insurance activity of the mortgage insurer be insuring against financial loss resulting from nonpayment of the mortgages and deeds of trust on residential structures.⁴⁴ Payment of kick-backs to a lender in return for that lender's placing of insurance with the mortgage insurer is prohibited, and violation of this prohibition is a ground

³⁹ *Request for Determination of Qualification of Private Mortgage Insurer*, Federal National Mortgage Ass'n, at 1.

⁴⁰ *Id.* at 1, ¶ 1.

⁴¹ *Id.* at 1, ¶ 2.

⁴² *Id.* at 2-3.

⁴³ *Id.* at 2, ¶ 4.

⁴⁴ *Id.* at 1, ¶ 2.

for disqualification.⁴⁵ In the underwriting area, the mortgage insurer is required to demonstrate, prior to FNMA approval, that its staff possesses the technical expertise to underwrite mortgage loans.⁴⁶ Subsequent to approval, the mortgage insurer must agree to permit periodic audits by FNMA of its operating policies and procedures, as well as its financial records.⁴⁷ However, while the mortgage insurer's policies and procedures are subject to scrutiny by FNMA, the standards give no guidance with regard to required operational and business practices, other than the prohibition on kickbacks.

FHLMC also established standards which mortgage insurers are required to meet in order to achieve and maintain the status of a qualified private insurer. Because the FHLMC requirements are far more formal and detailed than FNMA's and because private mortgage insurance issues are currently more central to FHLMC's operations than to FNMA's the remainder of this article will focus upon FHLMC's requirements.

B. *FHLMC Eligibility Requirements*

The FHLMC Board of Directors adopted its first "Eligibility Requirement for Private Mortgage Insurers" in 1971. Except that the requirements were clearly mandatory standards and not guidelines or exhortations to the industry, many of the initial FHLMC requirements were substantially similar to FNMA's, emphasizing financial solidity rather than quality underwriting. Like FNMA, FHLMC established a minimum capital requirement of \$5,000,000, but provided some leniency in the case of companies which had an established record. Companies which had been in business prior to 1971 could, in FHLMC's discretion, be given forty-eight months from the time of application to meet the requirements.⁴⁸ Again similar to FNMA's requirements, the insurer's outstanding liability could not exceed twenty-five times its policyholders' surplus.⁴⁹ The insurer was required, not merely encouraged, to limit its business to the insurance against loss by reason of nonpayment of indebtedness secured by mortgages or deeds of trust on residential structures.⁵⁰ Kickbacks to lenders in connection with the placement of insurance by that lender were prohibited.⁵¹ Copies of reports filed by the mortgage insurer with state insurance regulatory authorities, shareholders and the Securities and Exchange Commis-

⁴⁵ *Id.* at 2, ¶ 6.

⁴⁶ *Id.* at 1, ¶ 3.

⁴⁷ *Id.* at 3-4.

⁴⁸ *Eligibility Requirements for Private Mortgage Insurers*, "Financial Requirements," Federal Home Loan Mortgage Corp. (1971) at ¶ 1.

⁴⁹ *Id.* at "Operational," ¶ 2.

⁵⁰ *Id.* at "Basic Requirements," ¶ 3.

⁵¹ *Id.* at "Operational," ¶ 3.

sion were required to be submitted to FHLMC in addition to copies of audit reports submitted to the mortgage insurer by state insurance examiners.⁵² FHLMC also reserved the right to audit the approved insurer and to require such certificates as were deemed necessary to demonstrate the mortgage insurer's compliance with FHLMC's requirements.⁵³

However, FHLMC's requirements even in the early days went beyond FNMA's in several ways. There were additional requirements aimed at adequate financial solidity in the event the insured mortgage went into default. The establishment of the contingency reserve in an amount equal to 50% of earned premiums was required.⁵⁴ The insurer was required to maintain an adequate loss reserve,⁵⁵ and at least 85% of the insurer's total assets were required to be maintained in marketable securities and other highly liquid investments.⁵⁶ Losses in excess of 35% per year in two consecutive years would result in suspension.⁵⁷ FHLMC imposed some additional business requirements. FHLMC attempted to protect the insurer, and thus the lender and ultimately itself, from an overconcentration of risk by prohibiting the insurance of loans secured by properties in a single housing tract or continuous tracts in excess of 10% of the policyholders' surplus.⁵⁸ The insurer's risk for each loan was required to be limited to a maximum of 20% of the borrower's indebtedness to the insured, and the insurer was required to retain the right of election to pay the contractual portion or to pay the full amount of the loss and take title to the property.⁵⁹ Finally, prior to FHLMC approval, the insurer was required to be licensed to do business in three states, rather than in one as required by FNMA.⁶⁰ Thus, the FHLMC approved insurers had also met the statutory or regulatory requirements of at least three other jurisdictions.

However, while FHLMC had somewhat more stringent requirements than FNMA, the requirements were substantially similar in content and level of detail. The focus of the requirements imposed by both corporations was upon the insurer's assets to assure that in the event of loss from default by the borrower, the insurer had the resources to pay the claim. In 1971, little attention was given to the issue of how to prevent loss by assuring that the loans insured by the mortgage insurer were of sufficiently

⁵² *Id.* at "Reports and Certificates," ¶ 2.

⁵³ *Id.* at ¶ 4-5.

⁵⁴ *Id.* at "Financial Requirements," ¶ 3.

⁵⁵ *Id.* at ¶ 4.

⁵⁶ *Id.* at ¶ 5.

⁵⁷ *Id.* at "Operational," ¶ 4.

⁵⁸ *Id.* at "Basic Requirements," ¶ 5.

⁵⁹ *Id.* at "Operational," ¶ 1.

⁶⁰ *Id.* at "Basic Requirements," ¶ 1.

high quality to avoid a percentage of defaults so high that the mortgage insurer's financial solidity, and thus its ability to pay claims, was impaired. Further, both corporations established the right to oversee the mortgage insurer's business, but the scope of that oversight was not clearly defined.

A major revision of the "FHLMC Eligibility Requirements for Private Mortgage Insurers," adopted by the Board of Directors in June of 1973 put the requirements essentially into their present form.⁶¹ These 1973 eligibility requirements were far more detailed than the prior ones. The focus was no longer primarily upon financial requirements. Instead, the requirements imposed upon mortgage insurers seeking to achieve and maintain approved status were divided into several areas: financial, business, underwriting and administration.

The financial requirements, aimed at insuring the solidity of the mortgage insurer so FHLMC would be assured of the mortgage insurer's ability to pay claims, remained virtually identical to the financial requirements previously in effect.⁶²

The business requirements also remained very similar, with one major exception.⁶³ A new diversity requirement was added to the previously existing limitation upon the amount of insurance that could be written for properties in a single housing tract or contiguous housing tracts. Under the new diversity requirement, no mortgage insurer was permitted to have more than 20% of its total insurance in force in any one Standard Metropolitan Statistical Area (SMSA), or more than 60% of its insurance in force in one state.⁶⁴ The Board of Directors retained authority to alter these percentages in particular cases upon a determination that the economic condition of the SMSA's or the states in which an insurer has insurance in force or certificates of authority require such alteration. This additional requirement was based upon a recognition of the fact that defaults by mortgagors frequently occur because of a downturn in local economic conditions with resulting unemployment. This risk is not totally alleviated by careful underwriting of the insured lender or individual loans. The requirement that the mortgage insurer's risk be diversified geographically represents an attempt to decrease the likelihood that the mortgage insurer will be called upon to pay claims in excess of its ability to do so, even assuming it has met FHLMC's requirements of financial solidity. Under

⁶¹ *Eligibility Requirements for Private Mortgage Insurers*, Federal Home Loan Mortgage Corp. (1973).

⁶² *Id.* at § 130.

⁶³ *Id.* at § 120.

⁶⁴ *Id.* at § 120.3.

the amended eligibility requirements, the mortgage insurer is no longer required to possess a certificate of authority in three states, but is simply required to have the certificates of authority necessary to meet the geographical diversity requirements.

The most significant aspect of the 1973 revisions as they relate to requirements imposed upon mortgage insurers was the addition of a section setting forth underwriting requirements.⁶⁵ This represented the first attempt to diminish the likelihood of losses occurring from defaults by requiring the insurer to follow specified good business practice, as opposed simply to imposing financial requirements to increase the likelihood that the insurer would be able to pay the claim should default occur. These requirements, unlike the financial requirements, have a substantial impact upon the relationship between the mortgage insurer and the insured lender.

As previously discussed, the standard practice in the mortgage insurance industry is to perform a detailed analysis of the lender prior to issuing it the master policy, after which the insurer relies primarily upon the insured lender's underwriting of individual loans. The FHLMC requirements related primarily to master policy underwriting. The 1973 eligibility requirements provided that prior to insuring loans for a particular lender, the insurer must thoroughly investigate and evaluate the lender.⁶⁶ The areas of required investigation included the lender's underwriting capacity in terms of the quality of the lender's appraisal and underwriting ability; the lender's net worth; the quality of the lender's assets; the ability and past performance of the lender's servicing staff; and the adequacy of the lender's servicing procedures. No substantive standards were set by FHLMC with regard to acceptable lender quality or performance. The mortgage insurer was required to prepare and retain a report indicating that the investigation was made, and containing all information received in the course of the investigation, and including the insurer's judgment or evaluation of each factor. The information obtained in the course of the initial evaluation was required to be updated at least once every two years.⁶⁷ The initial and ongoing investigation requirements were the same regardless of whether the lender was a governmentally regulated institution. As under the pre-1973 eligibility requirements, the only requirements regarding the contents of the master policy were the limitations on the insurer's risk per loan (25% of the entire indebtedness to the insured) and the insurer's right of election.⁶⁸

⁶⁵ *Id.* at § 125.

⁶⁶ *Id.* at § 125.2(a).

⁶⁷ *Id.* at § 125.2(b).

⁶⁸ *Id.* at § 125.1.

The requirements for underwriting individual loans were phrased primarily in terms of the information the insurer must collect from the lender prior to determining whether to insure a particular loan. Determinations as to how to evaluate the information remained in the discretion of the insurer. The mortgage loan underwriting process falls into two basic areas: (1) the evaluation of the borrower's credit to determine the likelihood of repayment of the loan, and (2) the appraisal of the mortgaged property to determine whether the value of the security is adequate to protect the lender in the event the borrower defaults. In the first area, if the loan to value ratio exceeded 90% and the property was within an SMSA, FHLMC required the insurer to obtain a "Factual Data Credit Report" on the form prescribed by FHLMC.⁶⁹ Otherwise, the insurer was required merely to obtain a written credit report, which could be prepared by the lender, containing sufficient information on the borrower's employment status and credit history upon which to base an informed credit decision.⁷⁰ The insurer was similarly required to obtain an appraisal report containing sufficient information upon which to base an independent judgment of the value of the security property.⁷¹ If the property was located in an SMSA, the appraisal was required to contain a stated value based upon the market approach and supported by a comparison of at least three comparable properties.⁷² In all cases, the insurer was required to obtain at least one clear photograph of the security property. Finally, the insurer was required to develop a program for testing and evaluating appraisals the insurer received from the lender.⁷³ Specified appraisal and credit information on each insured loan was required to be maintained by the lender as part of the insured mortgage record.⁷⁴

An additional provision in the underwriting area dealt not with collection of data, but rather was intended to assure the integrity of the underwriting process itself. This provision required separation of the insurer's underwriting and sales functions. Employees of the insurer who were responsible for insurance sales were prohibited from underwriting, approving insurance or testing the insurer's appraisal methods.⁷⁵

The final area in which the 1973 revisions to the eligibility requirements expanded the mortgage insurer's obligations was administrative requirements. The revised requirements retained the pre-1973 requirement

⁶⁹ *Id.* at § 125.4(a).

⁷⁰ *Id.* at § 125.4(b).

⁷¹ *Id.* at § 125.3(a).

⁷² *Id.* at § 125.3(b).

⁷³ *Id.* at § 125.3(c).

⁷⁴ *Id.* at § 125.5(c).

⁷⁵ *Id.* at § 125.5(a).

that the mortgage insurer file with FHLMC a copy of reports made by the insurer to state insurance regulatory authorities, stockholders and the Securities and Exchange Commission, as well as a copy of audit reports submitted to the mortgage insurer by state insurance examiners. The 1973 amendments also required mortgage insurers to file with FHLMC annual and quarterly reports on forms prescribed by FHLMC, in addition to any other reports which might be required.⁷⁶ It was made clear that continual compliance with the eligibility requirements was required, and the mortgage insurer must retain for at least three years documents and records necessary to demonstrate such continual compliance. All the mortgage insurer's records, underwriting practices and claims practices were specifically made subject to audit by FHLMC, and each auditor's daily fee of two hundred dollars plus expenses was established. Finally, annual submission by the insurer of a "Certificate of Compliance" with FHLMC requirements was required.⁷⁷

Although the primary result of the 1973 revisions to the eligibility requirements was the expansion in scope and detail of the requirements imposed by FHLMC upon mortgage insurers, an additional result was the placement of requirements and limitations upon FHLMC itself. FHLMC has no *de jure* authority to regulate mortgage insurers. Its power, as granted in Section 305 (a) (2) of the Federal Home Loan Mortgage Corporation Act,⁷⁸ is merely the power to determine whether loans insured by a particular mortgage insurer will be deemed eligible for purchase by FHLMC, *i.e.*, the power any purchaser has to determine whether the goods offered for sale to that purchaser meet its requirements. Further, FHLMC is not subject to the requirements of the Administrative Procedure Act.⁷⁹ However, FHLMC decided that despite these statutory provisions, it should concern itself with various due process issues. Therefore, the 1973 revisions to the eligibility requirements contained new provisions designed to grant certain procedural due process safeguards to mortgage insurers which applied for or sought to retain approved status.

Beginning in March 1972, mortgage insurers which applied for qualification but were denied approval by FHLMC were notified in writing of the reasons for disapproval. The mortgage insurer was then given an opportunity to be heard by the Executive Vice President of FHLMC (its then most senior officer) on the merits of the grounds cited for failure to

⁷⁶ *Id.* at § 170.

⁷⁷ *Id.* at § 180.

⁷⁸ 12 U.S.C. § 1454 (1979).

⁷⁹ 5 U.S.C. §§ 551-59 (1977).

qualify.⁸⁰ This constituted the extent of the disappointed applicant's due process right. The procedures whereby the mortgage insurer was to apply for a hearing and procedures whereby the hearing was to be conducted were not set forth.

While due process at the application stage was not detailed in the pre-1973 eligibility requirements, due process prior to suspension or disqualification of a mortgage insurer previously approved was totally absent. The requirements in effect prior to the 1973 revisions contained only one specific reference to suspension: a mortgage insurer which experienced losses in excess of the permissible loss ratio was suspended from qualification until it was recertified by FHLMC. However, the possibility of suspension was implicit in the prior eligibility requirements because the continual compliance provisions would have been meaningless if FHLMC had not had the power to suspend a mortgage insurer for noncompliance which occurred subsequent to initial approval. However, the availability of notice and hearing prior to suspension were not set forth.

The 1973 revisions substantively increased and explicitly stated the availability of procedural due process. Under the revised requirements, responsibility for daily dealings with the mortgage insurers was delegated by the Board of Directors to the management of FHLMC, whereas decision making authority regarding a mortgage insurer's approved status was retained by the Board.⁸¹ Thus, under the revised eligibility requirements, a mortgage insurer could no longer be approved or suspended at the discretion of FHLMC's Executive Vice President. Instead, these actions could only be taken at a higher level through affirmative votes of at least two of the three members of the Board of Directors. Further protection was provided in that the process by which the Board would make its decision together with the mortgage insurer's rights in the event it was dissatisfied with the decision were explicitly set forth.

In the matter of the initial determination of approval, under the revised eligibility requirements, application for approval was required to be made to the Board of Directors for its determination whether the applicant was to be deemed an eligible private mortgage insurer.⁸² If the decision was negative, the mortgage insurer then had thirty days from the date of receipt of the Board's decision to file a notice with the Board objecting to the decision and requesting a hearing in accordance with the procedures

⁸⁰ *Eligibility Requirements for Private Mortgage Insurers*, Federal Home Loan Mortgage Corp., "Basic Requirements," ¶ 2. (1972).

⁸¹ *Eligibility Requirements for Private Mortgage Insurers*, Federal Home Loan Mortgage Corp., § 100.2 (1973).

⁸² *Id.* at § 110.1-2.

set forth in the eligibility requirements.⁸³ Likewise, the Board of Directors retained the authority to decide whether a mortgage insurer should retain approved status, be disqualified or suspended.⁸⁴ The mortgage insurer was granted the right to file a written request for a hearing within thirty days of a Board suspension or disqualification order, as well as the right to request a stay of the order pending such hearing.⁸⁵ Finally, the mortgage insurer was explicitly given the right to apply to the Board of Directors for a waiver of any requirement set forth in the eligibility requirements as well as the right to a hearing if the application for waiver was denied.⁸⁶ The Board also retained the right to waive any requirement on its own initiative.⁸⁷

The procedures applicable to the conduct of these hearings were also set forth in the 1973 revisions to the eligibility requirements. If a hearing was requested by a mortgage insurer pursuant to any of the provisions set forth above, the Board of Directors was required to establish a hearing date no more than sixty days after receiving such request.⁸⁸ The hearing was to be conducted by the presiding officer designated by the Board, who was given the responsibility for conducting the hearing in a fair and impartial manner.⁸⁹ The presiding officer's powers included: requiring the production of documents, receiving the ruling upon the admissibility of evidence, taking depositions or causing them to be taken, holding settlement conferences and ruling upon motions other than a motion to dismiss or one which would result in a final determination on the merits. All parties were given the right to submit oral or documentary evidence and to conduct cross-examination. Hearings were to be recorded and the record made available to any party.⁹⁰ The presiding officer was then required within thirty days to certify the record, including his or her recommendation, to the Board for decision.⁹¹ The Board was then required to render a decision within forty-five days.⁹²

After the 1973 revisions, no further revisions were made to the eligibility requirements for over five years. During this time, however, the mortgage insurance industry experienced substantial growth and FHLMC's

⁸³ *Id.* at § 110.3.

⁸⁴ *Id.* at § 200.1.

⁸⁵ *Id.* at § 200.2-3.

⁸⁶ *Id.* at § 190.1-2.

⁸⁷ *Id.* at § 190.3.

⁸⁸ *Id.* at § 210.3.

⁸⁹ *Id.* at § 210.4.

⁹⁰ *Id.* at § 210.6.

⁹¹ *Id.* at § 210.7.

⁹² *Id.* at § 210.8.

experience with the industry increased as well. Thus, by 1978, certain amendments to the eligibility requirements were believed to be needed in order to incorporate the results of this experience and to bring the requirements more into line with actual practices in the mortgage insurance industry. The 1978 amendments increased the stringency of the requirements where necessary to deter harmful competitive practices and to provide additional flexibility where appropriate. These amendments fell into the following basic areas: master policy underwriting (investigation of the lender), appraisal requirements for individual loans submitted by the insured lender, conflict of interest prohibitions and sanctions which could be imposed upon mortgage insurers found to be in violation of the eligibility requirements. No changes in the financial requirements, business requirements, or in the hearing procedures were deemed necessary despite the passage of time since the requirements had been adopted.

A number of mortgage insurers had complained for several years about the difficulties in complying with the requirements for initial investigation and evaluation of the lender. They had found it difficult to investigate and evaluate the lenders' underwriting capacity, net worth, and quality or assets, ability and past performance of its servicing staff, and the adequacy of its servicing procedures because the lender frequently refused to provide the necessary information. If the mortgage insurer demanded the information as a condition to insuring loans, the lender merely threatened to insure its loans elsewhere. The initial investigation requirement was therefore perceived as favoring the larger and more established insurers which generally had this information on the lenders with which they dealt, at the expense of newer insurers which did not have the information and were unable to require it without losing their competitive position.

In order to deal with this problem, an amendment was adopted which abolished the requirement that the mortgage insurer obtain the specified information prior to insuring loans with a particular lender. The amendment instead encouraged the mortgage insurer to investigate and evaluate the lender as to those factors. If the mortgage insurer was unable to obtain the necessary information from the lender, the insurer's files had to demonstrate that reasonable efforts had been made to obtain the documentation. Further, the mortgage insurer was required to develop a system whereby a sufficient number of loans submitted by the lender were reviewed in adequate detail to ensure their quality.⁹³ In addition, rather than conducting a new investigation every two years as previously required, the 1978 revision required the mortgage insurer to maintain and update

⁹³ *Eligibility Requirements for Private Mortgage Insurers*, Federal Home Loan Mortgage Corp., § 125.2(a) (1978).

at least quarterly certain statistics regarding its business with each lender. This procedure would enable the insurer to evaluate each lender's quality of underwriting and appraisal capacity, net worth and quality of assets, ability and performance of the servicing staff, and the adequacy of servicing procedures.⁹⁴ This continual analysis of the insurer's business relationship with the lender had become a fairly standard procedure in the mortgage insurance industry aided by the increasing mechanization of that industry. An additional advantage was that even if the lender refused to provide relevant information, the mortgage insurer would not be precluded from complying with this eligibility requirement because the information could be obtained from the lender through the insurer's analysis of its business with that lender. FHLMC thus continued its requirement that the mortgage insurer obtain the information needed to ensure that the loans insured were of sufficiently high quality without imposing an unfair burden upon newer mortgage insurers, and facilitated compliance with the eligibility requirements without damaging the insurer's competitive position.

The appraisal requirements supporting the underwriting approval of mortgage insurance upon a particular property were greatly expanded to detail precisely what mortgage insurers were to require from lenders whose loans they insured. The revised provision also conformed, to the extent possible, the FHLMC requirements for mortgage insurers to the FHLBB requirements for FSLIC insured lenders.⁹⁵ However, while the revised provision set forth more detailed and stringent standards, it also provided greater flexibility. A provision was added to make it clear that in determining the adequacy of a mortgage insurer's appraisal procedures, FHLMC would consider factors relating to the individual insured lender, the individual loan in question, and the nature and experience of the insurer's dealings with the lender.⁹⁶ This new provision reflected a recognition that the adequacy of a particular appraisal was to some extent determined by the situation. A loan submitted by a large and well established lender with which the insurer had a long history of successful dealing would realistically require a lesser degree of scrutiny than that of a small new lender with which the insurer had never before dealt. Therefore, an appraisal report deemed inadequate in the latter situation might be perfectly acceptable in the former.

The 1978 revisions to the eligibility requirements included a provision aimed at dealing with the previously discussed problem of the

⁹⁴ *Id.* at § 125.2(b).

⁹⁵ *Id.* at § 125.3(a).

⁹⁶ *Id.* at § 125.3(b).

placement of compensating balances.⁹⁷ The payment of kickbacks continued to be prohibited by the conflict of interest provisions. In addition, under the revised conflict of interest section, a mortgage insurer, its parent or another affiliate of the parent was prohibited from placing or maintaining funds on deposit with a lender with which the insurer has insured loans for the purpose of inducing the lender to insure loans with the insurer. Because the motive of inducement is difficult to prove, the section also provided that with the exception of commercial checking accounts and normal deposits in support of an active bank line of credit (where the lender receives a direct business benefit from the deposit) any deposit by an insurer placed or maintained with a lender is subject to full disclosure to FHLMC upon request. If the facts disclosed indicate a violation, FHLMC can then take appropriate action. In this manner, FHLMC attempted to strike an appropriate balance, by retaining appropriate authority to deal with harmful competitive practices without interfering with legitimate business relationships.

Finally, in 1978 a new section was added to the eligibility requirements making it clear that FHLMC had the power to deal with violations of the eligibility requirements other than by suspension or disqualification of the mortgage insurer.⁹⁸ FHLMC may give an informal warning to the insurer expressing concerns and suggesting possible remedial action. A formal written warning may also be given requiring corrective action and giving the mortgage insurer a specified amount of time in which to take such action. A copy of this warning will be given to the insurer's board of directors. Finally, the insurer may be suspended or disqualified in accordance with the procedure set forth in the eligibility requirements. These revisions, in effect, merely codified prior existing practice. It was not uncommon in the course of the annual audit of a mortgage insurer for FHLMC auditors to note violations of the eligibility requirements and set a time limit for correcting the problem. Of course, explicit provision had been made for suspension and disqualification prior to the 1978 revisions.

B. *Previous Challenge to FHLMC Eligibility Requirements*

While elaborate administrative hearing procedures are set forth in the FHLMC eligibility requirements, the opportunity to use these procedures has arisen only once. In 1975, a mortgage insurer's application for approval by FHLMC and simultaneous request for a waiver of certain requirements were denied and the mortgage insurer requested a hearing pursuant to the eligibility requirements. There resulted proceeding captioned *In Re: Application of Mid Atlantic Mortgage Insurance, Inc., for*

⁹⁷ *Id.* at § 150.2.

⁹⁸ *Id.* at § 200.

*Waiver of the Five Million Dollar Minimum Capital Requirement Established by Section 130.1 of the Eligibility Requirements for Mortgage Insurers.*⁹⁹ This proceeding represents the only formal challenge made to FHLMC's eligibility requirements in terms of FHLMC's authority to promulgate such requirements, the substance of the requirements themselves, or the application of the substantive requirements to a particular factual situation. There have been no cases in the suspension or disqualification area, since no insurer has ever been suspended or disqualified.

Consideration of *Mid Atlantic* is instructive, not only because it illustrates the operation of the hearing procedures, but because the decision of the Board of Directors concisely sets forth FHLMC's statutory authority to promulgate eligibility requirements for mortgage insurers and the standard of proof that must be met by an insurer to overturn a requirement established by FHLMC.

The following factual situation gave rise to the *Mid Atlantic* case. Mid Atlantic Mortgage Insurance, Inc., a small mortgage insurer with less than \$1,000,000 in capital, applied for approval by FHLMC in December 1974. It concurrently applied for a waiver of the minimum capital requirement. FHLMC denied these applications in March 1975 and subsequently denied Mid Atlantic's request for reconsideration of the decision. Mid Atlantic then requested a hearing which was granted. The hearing was held in June 1975 before a presiding officer appointed by the Board of Directors.¹⁰⁰

At the hearing Mid Atlantic raised essentially three issues. First, it alleged that FHLMC lacked statutory authority to establish requirements, including a minimum capital requirement, or to require that private mortgage insurers meet such requirements prior to being qualified by FHLMC. Mid Atlantic contended that the Federal Home Loan Mortgage Corporation Act did not authorize FHLMC to undertake a comprehensive regulation of the industry. Instead, Mid Atlantic contended that FHLMC should rely upon state regulation and approve any mortgage insurer licensed in the state or states in which it transacted business. It cited the McCarran-Ferguson Act to support its contention that Congress had intended in regulation of insurance to remain under the exclusive jurisdiction of the states. However, the McCarran-Ferguson Act argument was not developed beyond the mere statutory citation.¹⁰¹

In addition to contending that FHLMC lacked authority to promul-

⁹⁹ (FHLBB 1975).

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

gate its own eligibility requirements, Mid Atlantic took issue with the substance of the requirements and the particular application of the requirements to Mid Atlantic. It contended that the \$5,000,000 requirement was an arbitrary and unreasonable one, citing the far lower minimum requirements imposed by the states. Mid Atlantic also contended that the requirement had an anticompetitive effect because it created a barrier to entry of new companies into the market. Finally, the company contended that even if the requirement itself were reasonable, it should have been waived for Mid Atlantic. In support of this contention, Mid Atlantic cited compensating factors which provided adequate protection to FHLMC notwithstanding Mid Atlantic's limited capital. These factors included Mid Atlantic's refusal to insure loans other than top quality ones, its membership in the Maryland Insurance Guarantee Association and its localized approach to insurance.¹⁰²

All of these arguments were rejected by the presiding officer and subsequently the Board of Directors. On the first issue, the presiding officer found that the FHLMC Act gave FHLMC sufficient authority to establish eligibility requirements as a prerequisite to approving a company as a qualified private mortgage insurer, notwithstanding the fact that states might impose less stringent requirements. This finding was accepted by the Board of Directors and made a part of its decision.¹⁰³

FHLMC's authority was found to be derived from several sections in the FHLMC Act. First, the language in Section 305 (a) (2) which permitted FHLMC to purchase conventional mortgages having a loan to value ratio exceeding 80% if the unpaid principal balance of the mortgage over 80% was guaranteed or insured by "a qualified insurer as determined by the corporation," was found to indicate a Congressional intent to give FHLMC broad discretion in establishing qualifications, including minimum capital requirements. In addition, Section 305 (a) (1) which empowered FHLMC to purchase and sell mortgages required that FHLMC's secondary market operations "be confined so far as practicable to residential mortgages which are deemed by the corporation to be of such quality, type and class as to meet generally and purchase standards imposed by private institutional mortgage investors."¹⁰⁴ By necessary implication, FHLMC is required by this statutory provision to determine what types of mortgages would be acceptable to private institutional mortgage investors, and then to implement this determination by setting standards for the mortgages it will purchase.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

The Board found that any doubt as to the extent of FHLMC's authority to set such standards for mortgage insurers, notwithstanding conflicting state law provisions, was resolved by the specific Congressional directive in Section 310 of the FHLMC Act.¹⁰⁵ That section provides that "powers and functions of the corporation and of the Board of Directors shall be exercisable, and the provisions of this title shall be applicable and effective, without regard to any other law."¹⁰⁶ The word "law" is defined in Section 302 (c) of the FHLMC Act to include "any law of the United States or of any State."¹⁰⁷

The Board also found that the legislative history of the FHLMC Act supported its conclusion that FHLMC had the statutory authority to promulgate standards for mortgage insurers, without regard to action or inaction on the part of states.¹⁰⁸ The decision cited the provision in the Conference Report which indicated a Congressional intent to allow participation by private mortgage insurance companies in FHLMC's secondary market operations "under terms and conditions that require sound and ethical practices."¹⁰⁹ The Board concluded that this statement did not indicate any Congressional concern that FHLMC's secondary market activities be restricted by state law. Damage to FHLMC's secondary market activities could result if FHLMC sold securities supported by mortgage insurance written by inadequately capitalized mortgage insurers. The Board was unwilling to infer a Congressional intent to hamstring the corporation's secondary market activities.¹¹⁰

The issue of whether the standards set by FHLMC had any anti-competitive effect was also examined. Contrary to Mid Atlantic's contention, it was found that competition in the mortgage insurance industry had actually increased subsequent to FHLMC's adoption of eligibility requirements in 1971. The pattern of growing competition in the industry did not indicate that the FHLMC requirements constituted a substantial barrier to entry or hindrance to competition in the mortgage insurance industry.¹¹¹

While FHLMC is not only authorized, but in effect required by statute to set its own requirements without regard to the law or practice of any state, FHLMC was not found by the Board to have total freedom

¹⁰⁵ *Id.*

¹⁰⁶ 12 U.S.C. § 1454 (1979).

¹⁰⁷ *Id.* at § 1454(c).

¹⁰⁸ (FHLBB 1975).

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

to establish requirements. In setting such requirements, FHLMC is not permitted to act in an arbitrary and capricious manner. The presiding officer found the minimum capital requirement was neither arbitrary nor capricious, but was reasonable. This conclusion was accepted by the Board.¹¹²

The amount of the minimum capital requirements was found to be dictated largely by FHLMC's need to have its mortgage backed securities find a ready acceptance in the capital market. Because FHLMC was organized with relatively little capital (\$100,000,000), it is not in a position to purchase mortgages and hold them in its portfolio, but must turn to the capital markets. In order to raise capital, FHLMC must convince institutional investors that its mortgage backed securities are of unquestionable quality, and an important element of this quality is the potential ability of the insurer of the mortgages underlying the security to pay claims in the event of default on the mortgages. The reasonableness of the minimum capital requirement was therefore determined in light of the need to impress potential investors with the soundness of an investment in FHLMC securities. The minimum capital requirements set by the various states were found to be irrelevant to the reasonableness of FHLMC's standard because unlike FHLMC, state authorities are not primarily concerned with selling mortgage backed securities to private institutional investors.¹¹³

On the basis of all expert testimony in *Mid Atlantic*, it was found that the \$5,000,000 minimum capital requirement was necessary to enable FHLMC to sell its securities and raise the necessary capital to continue its mortgage purchase operations. There was testimony that the minimum capital requirements imposed by private institutional investors were at least as rigorous as FHLMC's. FHLMC's requirements could therefore be regarded as implementing the requirement of Section 305 (a) of the FHLMC Act that FHLMC's mortgage purchases be confined to loans which "meet generally the purchase standards imposed by private institutional mortgage investors." Further, expert testimony backed by computer simulations indicated that the \$5,000,000 capital requirement provided significantly greater protection to FHLMC than would a lesser requirement. The requirement was therefore not arbitrary and capricious. In fact, the Board indicated that an even higher requirement such as \$10,000,000 would also be reasonable, but that the \$5,000,000 requirement represented a balance among competing considerations. The amount was low enough to permit the number of private mortgage insurers to increase, but high enough to

¹¹² *Id.*

¹¹³ *Id.*

convince institutional investors that FHLMC securities are safe investments.¹¹⁴

On the final issue of whether Mid Atlantic should be granted a waiver of the \$5,000,000 capital requirement on the basis of the particular facts involved, the presiding officer and subsequently the Board found no merit in Mid Atlantic's contentions.¹¹⁵

Mid Atlantic sought judicial review of the Board's decision by filing suit in the United States Court of Appeals for the District of Columbia.¹¹⁶ FHLMC raised a jurisdictional objection contending that the case would properly have been filed in the United States District Court, not the United States Court of Appeals. These contentions resulted in a stipulated dismissal and the case was never refiled in the appropriate court. Thus, no court has ever considered either the issue of FHLMC's authority to establish eligibility requirements for mortgage insurers or the issue of whether particular requirements were arbitrary, capricious and therefore invalid.

D. *Potential Future Challenges to the FHLMC Eligibility Requirements*

Because no court has had the opportunity to rule on the FHLMC eligibility requirements, any discussion of a potential challenge to the requirements or the potential decision of a court is obviously speculative. However, it is likely that a controversy over the eligibility requirements would take one of two forms: a challenge to a specific requirement, as being arbitrary or capricious as in *Mid Atlantic*; or a challenge to FHLMC's authority to promulgate any requirements in view of the McCarran-Ferguson Act, a point raised in *Mid Atlantic* but not pursued.

Passage of the McCarran-Ferguson Act¹¹⁷ constituted an attempt by Congress to deal with the respective powers of the state and federal governments to regulate the insurance business, an issue with which the courts had been dealing for seventy-six years. From 1869 until 1944, the controlling case in the area was *Paul v. Virginia*,¹¹⁸ a criminal case involving prosecution for violation of a state criminal statute regulating insurance. In that case, the Supreme Court upheld a Virginia statute requiring that out-of-state insurance agents be licensed against a contention that the state statute constituted a restraint on interstate commerce. In upholding the statute and the defendant's conviction, the Court found first that issuing insurance policies was not a transaction of commerce, but rather a contract

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Mid-Atlantic Mortgage Ins., Inc. v. FHLMC*, No. 75-220 (D.C. Cir. 1975).

¹¹⁷ 15 U.S.C. §§ 1011-1015 (1964).

¹¹⁸ 75 U.S. 357 (1869).

of indemnity against loss.¹¹⁹ The Court further found that because the insurance policy did not take effect until delivered in Virginia, the transaction was purely intrastate.¹²⁰

The courts followed this position until 1944 when *United States v. Southeastern Underwriter Association* was decided.¹²¹ Defendants in that case had been indicted for fixing fire insurance premiums in violation of the Sherman Antitrust Act.¹²² Defendants contended that they were not required to conform to the business conduct standards required by the Sherman Act because the business of fire insurance did not constitute commerce.¹²³ The District Court agreed on the basis of *Paul v. Virginia*, and dismissed the indictment.¹²⁴ On direct appeal by the United States, the Supreme Court held that fire insurance transactions across state lines constituted interstate commerce and reversed the District Court's dismissal of the indictment.¹²⁵ The Court distinguished the case from *Paul* and cases following *Paul* on the grounds that in those prior cases the Commerce Clause had been cited to attempt to strike down state regulation, whereas in *Southeastern Underwriters*, the Commerce Clause was cited to uphold a federal regulation and not to interfere with state regulation of the insurance industry.¹²⁶

In reaction to the *Southeastern Underwriter* case, Congress enacted the McCarran-Ferguson Act¹²⁷ in 1945 to deal with resulting confusion as to the proper role of the state and federal governments in regulating insurance and to express an intent that regulation of insurance is the responsibility of the states unless Congress explicitly provides otherwise. The McCarran-Ferguson Act provided that no act of Congress should be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance unless such act specifically related to the business of insurance.¹²⁸

The McCarran-Ferguson Act provides a defense against federal action only if four conditions are met. First, the statute under which the challenged action is undertaken must not "specifically relate to the business of

¹¹⁹ *Id.* at 360.

¹²⁰ *Id.* at 361.

¹²¹ 322 U.S. 533 (1944).

¹²² *Id.* at 534-35.

¹²³ *Id.* at 536.

¹²⁴ *United States v. Southeastern Underwriters Ass'n*, 51 F. Supp. 712 (D.D.C. 1943).

¹²⁵ 322 U.S. 533 (1944).

¹²⁶ *Id.* at 542-53.

¹²⁷ 15 U.S.C. §§ 1011-15 (1964).

¹²⁸ *Id.* at § 1012.

insurance." Second, the activities regulated must be part of the "business of insurance." Third, the activities must be regulated by state law. Fourth, the federal action in question must "invalidate, impair, or supersede" state law.¹²⁹

Although in most McCarran-Ferguson Act cases there is no question that a federal action, if otherwise applicable, will invalidate, impair, or supersede state law, the issue is of prime significance in the case of the FHLMC eligibility requirements. As previously discussed, FHLMC has no regulatory authority over the mortgage insurance industry. FHLMC cannot require a mortgage insurer to undertake or refrain from particular acts and has no power to revoke a mortgage insurer's license to do business. Thus, regardless of any action by FHLMC, the rights private mortgage insurers may enjoy under state law are neither invalidated or impaired, and the state regimes are not superseded.

In contrast, virtually every case concerning the McCarran-Ferguson Act involves efforts to prohibit activities permitted under state law. In *Securities and Exchange Commission v. National Securities, Inc.*,¹³⁰ for example, the Securities and Exchange Commission sought to prohibit an insurance company merger approved by the State of Arizona. Similarly, in *Cochran v. Paco, Inc.*,¹³¹ the plaintiff invoked the Truth in Lending Act to prohibit use of an insurance financing disclosure statement which met state law requirements. In *Dexter v. Equitable Life Assurance Society*,¹³² the plaintiff relied on federal antitrust laws to prohibit the tying of mortgage insurance to mortgage loans. Finally, in *Group Life Health and Insurance Co. v. Royal Drug Co.*,¹³³ the plaintiffs invoked the antitrust laws to prohibit certain provided contracts between Blue Cross and pharmacies. FHLMC simply cannot attempt any such prohibition under the eligibility requirements.¹³⁴

As a practical matter, it might be argued that the FHLMC eligibility requirements curtail activities permitted by state law. This argument would be based upon the presumption that many mortgage originators will not deal with insurers who fail to meet FHLMC standards. The validity of the presumption is doubtful. There have been and presumably will be in

¹²⁹ See, e.g., *Securities Exchange Comm'n v. National Securities, Inc.*, 393 U.S. 453 (1969); *Cochran v. Paco, Inc.*, No. 76-1956 (5th Cir. Jan. 2, 1979).

¹³⁰ 393 U.S. 453 (1969).

¹³¹ No. 76-1956 (5th Cir. Jan. 2, 1979).

¹³² 527 F.2d 233 (2d Cir. 1975).

¹³³ 99 S. Ct. 1067 (1979).

¹³⁴ Indeed, in every case discussed in the text, the McCarran-Ferguson Act was raised as a defense. Since FHLMC would never need to bring an enforcement action based on the requirements, the Act would never be asserted as a defense.

the future viable private mortgage insurers which have not applied for approval under the eligibility requirements. However, even if the presumption is correct, the McCarran-Ferguson Act would not therefore be applicable to the eligibility requirements. The impact of the requirements on mortgage insurers would remain indirect and would depend upon the intervening actions of totally autonomous third parties. In these circumstances, the requirements would not invalidate, impair, or supersede state law, at least in the context in which those terms have been traditionally understood.

If the eligibility requirements curtailed the actions of mortgage insurers, the question would arise whether the FHLMC Act falls within the McCarran-Ferguson Act exemption for statutes which specifically relate to the business of insurance. Although the courts have not frequently addressed this exemption, the United States Court of Appeals for the Fifth Circuit recently construed the exemption narrowly. In *Cochran v. Paco, Inc.*,¹³⁵ the court concluded that an express statement that a statute applied to the business of insurance was required and that partial repeal of the McCarran-Ferguson Act should not be inferred from an over all statutory scheme.

In concluding that an express repealer was necessary, the *Cochran* court focused on both the language of the Act and its legislative history. The court noted that the Act reflected Congressional opposition to the holding of *South Eastern Underwriter Ass'n.* that insurance was interstate commerce and found that Congress intended to insulate the insurance industry from federal control.¹³⁶ As stated by the court:

Congress thus returned to the states the plenary power to regulate the business of insurance that they had enjoyed prior to the *Southeastern Underwriter* decision. If Congress intended to invoke its Commerce Clause powers to occupy part of the field of insurance regulation, it would expressly say so. Congress wanted to ensure that no future federal legislation enacted under the Commerce Clause and not specifically related to insurance would be construed as an implied repeal of the McCarran Act.¹³⁷

The court found support for this conclusion in statements made in Congress when the Act was passed. The court quoted Senator Ferguson as stating:

If there is on the books of the United States a legislative Act which relates to interstate commerce, if the Act does not specifically relate to insurance, it would not apply at the present time. Having passed

¹³⁵ No. 76-1956 (5th Cir. Jan. 2, 1979).

¹³⁶ *Id.*

¹³⁷ *Id.*

the bill now before the Senate, if Congress should tomorrow pass a law relating to interstate commerce, and should not specifically apply the law to the business of insurance, it would not be an implied repeal of the bill, and this bill would not be affected, because the Congress had not . . . said that the new law specifically applied to insurance.¹³⁸

Based on this analysis, the Fifth Circuit held that the Truth In Lending Act was not a statute specifically relating to the business of insurance. The court so held despite the fact that the Truth In Lending Act did make reference to certain insurance related charges.¹³⁹ The impact of this holding is somewhat softened, however, by the court's additional finding that those aspects of insurance company operations regulated by the Truth In Lending Act were not "the business of insurance" and consequently were not shielded from federal regulation.

Although it does not expressly refer to the McCarran-Ferguson Act, the FHLMC Act would most likely be considered a statute specifically relating to the business of insurance. Section 305 (a) (1) of the Act permits FHLMC to purchase mortgages "of such quality, type, and class as to meet generally the purchase standards imposed by private institutional mortgage investors."¹⁴⁰ Section 305 (a) (2) (C) prohibits FHLMC from purchasing a conventional mortgage if the outstanding principal balance exceeds 80% of the value of the property at the time of purchase, unless "that portion of the unpaid principal balance of the mortgage which is in excess of such 80 per centum is guaranteed or insured by a qualified insurer as determined by the Corporation."¹⁴¹ Thus, the FHLMC Act unambiguously evidences Congressional contemplation that FHLMC would adopt standards governing the private mortgage insurance acceptable to it. To the extent the affected activities of private mortgage insurers would otherwise be within the McCarran-Ferguson Act, these provisions must be considered a partial repeal of that Act.

This conclusion is buttressed by the legislative history of the FHLMC Act. The Conference Committee Report accompanying the Act makes it

¹³⁸ *Id.*

¹³⁹ The Truth in Lending Act defines "finance charge" as "the sum of all charges" imposed "as an incident to the extension of credit, including . . . premium or other charge for any guarantee or insurance protecting the creditor against the obligor's default or other credit loss." 15 U.S.C. § 1605(a).

¹⁴⁰ 12 U.S.C. § 1454(a)(1).

¹⁴¹ *Id.* at 1454(a)(2)(C).

clear that Congress intended FHLMC to have an impact upon the private mortgage insurance industry.¹⁴² The report states:

The conferees believe that private mortgage insurance can play an important role in developing an effective secondary market in conventional mortgage loans. We urge FNMA and the Federal Home Loan Mortgage Corporation to encourage their participation, under terms and conditions that require sound and ethical practices. Specifically, the conferees expect both FNMA and The FHLMC to take necessary steps by the issuance of rules and regulations and appropriate examination procedures to assure the prohibition of such conflict of interest practices as payment or rebates and commissions or other forms of compensation to officers, directors, or employees or mortgage lenders or groups of mortgage lenders.¹⁴³

If Sections 305 (a) (1) and 305 (a) (2) (C) were not *pro tanto* repealers of the McCarran-Ferguson Act, and that Act otherwise applied, the sections would be rendered meaningless. The only alternative available to FHLMC would be to adopt state law as the final standard by which private mortgage insurers were to be assessed. If Congress intended that state law standards be respected by FHLMC, then Congress would have had no reason to anticipate that FHLMC should promulgate "regulations and appropriate examination procedures."¹⁴⁴ An FHLMC abdication to state regulations is plainly not what Congress intended when it commanded in Section 305 that FHLMC evaluate mortgages and private mortgage insurers. There is a strong presumption against construing a statute so as to render it ineffective.¹⁴⁵ In short, before particular aspects of FHLMC's eligibility requirements would be judicially evaluated, a private mortgage insurer would first have to demonstrate both that the requirements invalidate, impair, or supersede state law and that the FHLMC Act does not specifically relate to the business of private mortgage insurance. These two hurdles are substantial and the cases strongly suggest that they cannot be overcome.

Most case law developed under the McCarran-Ferguson Act focuses on the question of what constitutes the business of insurance. The United States Supreme Court recently revisited this question in *Group Life Health*

¹⁴² H. R. REP. No. 91-1311, 91st Cong., 2d Sess. 1 (1970).

¹⁴³ *Id.* at 17.

¹⁴⁴ *Id.*

¹⁴⁵ See, e.g., *Bird v. United States*, 187 U.S. 118, 124 (1902); *United States v. Blasius*, 397 F.2d 203, 207 n.9 (2d Cir. 1968), cert. dismissed, 393 U.S. 1008 (1969); *Re White*, 266 F. Supp. 863, 866 (N.D.N.Y. 1967).

*Insurance Co. v. Royal Drug Co.*¹⁴⁶ The plaintiffs in *Group Life* sought to challenge as violations of antitrust laws the agreements between Blue Cross and selected pharmacies to provide drugs to Blue Cross subscribers at fixed prices. The question confronting the Court was whether the agreements were part of the business of insurance and consequently immunized from the antitrust laws by the McCarran-Ferguson Act. In concluding that the agreements between Blue Cross and the pharmacies were not the business of insurance, the Court relied on the principle established in *Securities and Exchange Commission v. National Securities, Inc.*¹⁴⁷ that the business of insurance did not encompass all the business activities of insurers.¹⁴⁸

The Court has defined the business of insurance, for purposes of the McCarran-Ferguson Act, to include only those activities directly concerning the relationship between the insurance company and the insured. As stated by the Court: "the relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement — these were the core of the 'business of insurance.'" ¹⁴⁹

A trilogy of decisions recently issued by the United States Court of Appeals for the Fifth Circuit illustrates the application of the fundamental principles laid down by the Supreme Court. In *Cochran v. Paco, Inc.*, the court considered whether the McCarran-Ferguson Act precludes application of the Truth In Lending Act's disclosure requirements to a credit agreement between a lending institution and a borrower who had obtained the loan to purchase automobile insurance.¹⁵⁰ In *Perry v. Fidelity Union Life Insurance Co.*, the issues presented were the same as in *Cochran*, except that the insurance company financed the policy premiums itself.¹⁵¹ In *Cody v. Community Loan Corp.*, a finance company sold borrowers life insurance policies issued by a sister corporation and deducted the initial premium for the loan.¹⁵² In each of these cases, the court concluded that the business of insurance was not involved and that consequently the Truth

¹⁴⁶ 99 S. Ct. 1067 (1979).

¹⁴⁷ 393 U.S. 453 (1969).

¹⁴⁸ 99 S. Ct. 1067, 1075-76; *See* 393 U.S. at 459-60.

¹⁴⁹ 393 U.S. at 460; *see* *Securities Exchange Comm'n v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (annuity contracts which paid return based on earning from investment of premiums, not on underwriting of risks, held not in business of insurance).

¹⁵⁰ No. 76-1956 (5th Cir. Jan. 2, 1979).

¹⁵¹ No. 76-2709 (5th Cir. Jan. 2, 1979).

¹⁵² No. 76-1687 (5th Cir. Jan. 2, 1979); it is not clear from the opinion whether the insurance was intended only to pay off the loan or whether it was wholly unrelated to the loan.

In Lending Act governed the transactions. These decisions thus show that many activities of insurance companies are not part of the business of insurance for purposes of the McCarran-Ferguson Act.

Certain aspects of the eligibility requirements unquestionably relate to the business of insurance. Most prominent among these are underwriting standards. Thus, if all other conditions were satisfied, the McCarran-Ferguson Act would insulate private mortgage insurers from these regulations. Certain of the requirements, however, may be sufficiently removed from the insurer-insured relationship to qualify for exemption. For example, a persuasive argument could be made that the conflict of interest provisions do not relate directly to the contractual agreement between lending institutions and private mortgage insurers.

The remaining consideration would be whether state law regulates the practice in question. This must be evaluated on a case by case basis. Most states, however, have comprehensive regulatory schemes for private mortgage insurers. Of course, as discussed above, the mere existence of state regulation is not sufficient to establish a defense. Whether the federal regulations invalidate, impair, or supersede state law is wholly distinct, and in the case of the eligibility requirements is a most important question.

V. CONCLUSION

This article has focused upon the history of the private mortgage insurance industry, its functioning and growth, and its interrelationships with other elements of the mortgage lending industry. The interrelationships among mortgage insurers, mortgage lenders, and the federal public secondary market have been mutually beneficial, and have facilitated the expansion of the entire mortgage lending industry. However, while an attempt was made to describe the existing private mortgage insurance industry and to explain how that industry developed, no attempt was made to discuss trends for the future. A brief look at those trends reveals a likelihood of continued growth of the mortgage insurance industry and strengthened interrelationships within the mortgage lending industry as a whole.

The number of private mortgage insurance companies doing business, the volume of business done by the industry as a whole, and the industry's importance to the mortgage lending industry have steadily increased over the years. There is no indication that this trend will not continue, even absent changes within the mortgage lending industry. In addition, there are at least three major factors likely to strengthen this trend.

First, while the focus of this article was upon interrelationships with

the savings and loan industry because that industry has traditionally supplied the majority of residential mortgage funds in this country, many of the relationships described here would apply to the mortgage finance industry generally, including commercial banks, mortgage bankers and credit unions. A variety of factors beyond the scope of this article, such as the Community Reinvestment Act and recent authority for direct mortgage banker access to FHLMC, will cause private mortgage insurance to become increasingly important to lenders other than savings and loan associations.

Second, an additional trend, which is beyond the scope of this article but which should have a profound impact upon the growth of the private mortgage insurance industry, is the fact that the private mortgage insurance companies are increasingly developing their own secondary market operations. As a result, the companies are no longer involved in the secondary market merely from the standpoint of making high ratio loans acceptable for purchase by FNMA and FHLMC, but rather are themselves purchasing, packaging and selling mortgage loans. This trend is likely to lead not only to growth, but to an entirely new set of interrelationships between the private mortgage insurance companies and the lenders.

Third, a further trend is the increasing involvement of private mortgage insurers in the issuance of private mortgage backed securities as blanket insurers of the pool of mortgages underlying the securities, as review underwriters for a fee of the underlying mortgages, and as advisors and consultants in the structuring and marketing of the securities. Thus, it appears likely that the private mortgage insurance industry will undergo substantial changes, as well as continued growth, in the foreseeable future.