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Private Mortgage Insurance: Cancellation Options

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Summary

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

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

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

The Homeowners Protection Act of 1998, P.L. 105-216, was enacted to address the issue. The law requires disclosure of the right to cancel mortgage insurance. The Act requires lenders to terminate PMI upon written request by borrowers whose loan balances have reached 80% of the original property value, and it provides for mandatory cancellation once the loan balance reaches 78% of the original value of the property securing the loan. The provisions cf the Act covering PMI become effective on July 29, 1999, and in general, apply to loans originated on or after July 29, 1999.

Technical corrections to the Act were enacted in Title IV of P.L. 106-569, which is cited as the Private Mortgage Insurance Technical Corrections and Clarification Act.

Introduction

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

The FHA home loan insurance program was begun in the 1930s, when lenders had largely withdrawn from the mortgage market. The program was designed to encourage lenders to begin making long-term mortgage loans again. FHA agreed to pay for the lenders' losses if the borrowers defaulted on the loans. (See RS20530, FHA Loan Insurance Program, an Overview.)

In the 1950s, private insurers saw the value of providing a similar service to the higher end of the mortgage market (FHA-insured loans are generally limited to 95% of an area's median home price). By the 1970s, private insurers were originating a larger volume of loans than FHA. That changed in the late 1980s when the private insurers tightened their underwriting standards because of the large losses the industry was experiencing. From 1986 until 1990, FHA wrote a larger volume of loans than the private insurers. Since 1991, the private insurers have again been producing the largest volume of insured loans, except 1994 when FHA insured more loans.

Canceling Mortgage Insurance

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

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

Under Fannie Mae guidelines, at the time of loan origination and annually, borrowers must be informed that their PMI may be canceled if certain conditions are met. The mortgage insurance may be canceled when a borrower with a good payment history

accumulates equity in the home that is equal to 20% of the home's original value, whether the equity was accumulated through prepayment of part of the loan or amortization of the loan. When a loan reaches its "half-life" (15 years on a 30-year mortgage and 7.5 years on a 15-year mortgage) and the loan is current, the mortgage insurance will be automatically canceled.

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

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

Reportedly, there was widespread industry practice of requiring and collecting mortgage insurance premiums from borrowers when it is no longer necessary. Since the protections that PMI offers flow to parties that are not paying the insurance, market discipline does not necessarily address the problem. In some cases the insurance could be discontinued, but the burden was placed on the borrowers to request cancellation, and the borrowers were not aware of that option. Until 1998, no federal law required disclosure of the option. Fannie Mae and Freddie Mac have guidelines permitting PMI cancellation, but in the past neither agency had required disclosure of the option.

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

It was alleged that borrowers could be paying $240 to $1,200 annually for mortgage insurance that was no longer needed. Dozens of class action law suits were filed against lenders for failure to make that disclosure. Legislation was enacted in the 105th Congress to address the issue.

The Homeowners Protection Act of 1998

The Homeowners Insurance Protection Act (H.R. 607) was introduced on February 5, 1997, and was passed by the House on April 16, 1997. The Homeowners Protection Act of 1997 (S. 318) was introduced on February 12, 1997, and was passed by the Senate on November 9, 1997. As amended by both houses, S. 318 was cleared for the White House on July 16, 1998, and signed into law on July 29, 1998, as the Homeowners Protection Act of 1998 (P.L. 105-216). The provisions of the Act covering PMI became effective on July 29, 1999, and, in general, the provisions apply to mortgages originated on or after July 29, 1999.

Technical corrections to the Act were enacted in Title IV of P.L. 106-569, which is cited as the Private Mortgage Insurance Technical Corrections and Clarification Act.

Cancellation at Borrower Request. The Act requires lenders to terminate PMI upon written request by borrowers whose loan balances have reached 80% of the original property value. As amended by P.L. 106-569, four conditions have to be met: (1) borrowers must submit written requests that cancellation be initiated, (2) borrowers must have good payment histories as defined in the Act, (3) borrowers must be current on the payments required by the terms of the mortgage, and (4) borrowers have to satisfy any lender requirement for evidence that the value of the property has not declined below the original value and for certification that the equity in the property is not encumbered by subordinate liens. Borrowers have a choice of determining whether the 80% of value is based on the initial amortization schedule or on actual payments made by the borrowers. Amendments in P.L. 106-579 provide that for adjustable rate mortgages the determination is based on the amortization schedule then in effect. Senate report language for S. 318 indicated that the law is not intended to create a 20% minimum equity requirement for PMI cancellation but that it creates a floor and lenders may not impose more restrictive requirements.

Automatic Termination. The Act provides for automatic termination of the PMI requirement once the loan balance reaches 78% of the original property value. Amendments in P.L. 106-579 provide that if the borrower's payments are not current on the termination date, then PMI will be automatically cancelled on the first day of the first month after the date on which the borrower becomes current on the payments. The amendments also provide that, for adjustable rate mortgages, the determination is based on the amortization schedule then in effect. Additionally, the Act provides that PMI will no longer be required once the loans reached their half-life, if the borrowers are current on their payments.

Exceptions for High Risk Loans. Exceptions are provided for loans defined as high risk under guidelines published by Fannie Mae and Freddie Mac, or under similar guidelines determined by lenders. Under such loans, lenders will not be required to cancel the PMI requirement upon the request of the borrowers, but the PMI requirement would

terminate on the date that the loan balance is scheduled be at 77% of the original property value. The cancellation date is based solely on the original amortization schedule, and the PMI requirement must be canceled regardless of the actual loan balance on that date. For these high risk mortgages, the PMI requirement will also terminate at the half-life of the loans if the payments are current.

Exceptions for Loans with Lender-Paid Mortgage Insurance. The Act also provides an exception from PMI cancellation on loan transactions on which the PMI is paid by someone other than the borrowers. On certain transactions, for example, the borrowers may pay higher than market interest rates, and obtain loans under which the borrowers do not pay any discount points or PMI. In effect, these costs are built into the interest rates and capitalized over the life of the loans. To subject such loans to PMI cancellation would be to penalize the lenders who make the loans and pay the costs on behalf of the borrowers. Thus, lenders would be discouraged from offering a loan product that has been useful to borrowers with limited up-front funds. The Act provides that such loans will not be subject to borrower-initiated or automatic PMI cancellation.

The Act requires that lenders provide such borrowers with written notice: (1) that the borrowers have no statutory right to request PMI cancellation, while borrowers under other loan programs have such rights in addition to automatic PMI termination at some point; (2) that the loans usually result in higher interest rates than would otherwise be required, and that PMI is terminated only when the loans are paid off or refinanced, (3) that there are advantages and disadvantages to the loan program, and (4) that the lender-paid mortgage insurance may be tax deductible.

Disclosure Requirements. The Act requires several disclosures for newly originated loans. Except for high risk loans and adjustable rate mortgages, lenders are required to provide the borrowers with written amortization schedules. Additionally, borrowers are to be provided with written notice: (1) that the borrowers may cancel the PMI obligation once the loan balances have reached 80% of the original property value, and indicating the date on which such cancellation may be requested based upon the amortization schedule; (2) that the borrowers may cancel the PMI at an earlier date once loan balances have reached 80% of the original property value, based upon actual payments; (3) that the PMI requirement will automatically terminate when loan balances have reached 78% of the original property value, and indicating the cancellation date; and (4) that there are exemptions to these cancellation requirements, and indicating whether such exemptions apply in these cases.

For high risk loans, lenders are required to provide written notice that PMI may not be required beyond the half life of the loans, if the loans are current. On adjustable rate mortgages, lenders must provide the borrowers with notice that the borrowers may cancel the PMI obligation once loan balances have reached 80% of the original property value, and that the lender will notify the borrowers when the cancellation date is reached.

On all newly originated loans that require PMI, lenders are required to provide borrowers with annual written statements disclosing the rights of the borrowers to cancel the PMI. Borrowers must be given the address and telephone number the borrowers may use to determine that information.

On mortgages originated prior to July 29, 1999 and which required PMI, lenders are required to provide annual written statements which disclose that PMI may be canceled under certain circumstances with the consent of the lender and in accordance with applicable state law. Borrowers must be given the address and telephone number the borrowers may use to contact the lenders.

Law Not Applicable to FHA, VA or Rural Housing Loans. Section 2(11) of the Act defines "private mortgage insurance" as mortgage insurance *other than that made available* under the National Housing Act, Title 38 of the United States Code, or Title V of the Housing Act of 1949. The home loan insurance programs of FHA are authorized under the National Housing Act, the guaranteed home loan program of VA is authorized under title 38 of the United States Code, and the rural housing programs of the Rural Housing Service (RHS) of the Agriculture Department are authorized under Title V of the Housing Act of 1949. Thus, the provisions of the Act do not apply to FHA, VA, or USDA housing loans.

Borrowers under the VA and RHS programs do not pay any monthly or annual mortgage insurance, so any cancellation of the insurance or guarantee would provide no economic benefit to borrowers. The FHA program is an insurance program, but it operates differently than private mortgage insurance. Under private mortgage insurance programs, only the top 20% to 30% of the loan is insured, so it is reasonable that once a borrower has equity of 20% or more in a mortgaged property, there may no longer be a need for mortgage insurance. Under the FHA insurance program, however, the whole loan is insured. Since the government is always at risk for the whole loan, there is little rationale for the lender to cancel the insurance.

Current regulations provide, however, that FHA insurance may be canceled upon request by the borrower and the lender. The decision depends on who owns the loan. If the loan is owned by Fannie Mae, then Fannie Mae permits the FHA insurance to be canceled if the borrower and lender agree. If the loan is owned by Freddie Mac, then Freddie Mac requires that the FHA insurance be maintained as long as the loan is outstanding. Most FHA loans, however, are part of Government National Mortgage Association (Ginnie Mae) mortgage pools, and Ginnie Mae permits the insurance to be cancelled according to the FHA rules.

FHA has revised its rules to provide that, for loans closed on or after January 1, 2001, the annual mortgage insurance premium will be automatically cancelled when, based on the initial amortization schedule, the loan balance reaches 78% of the initial property value. Borrowers may also request cancellation of the mortgage insurance when the 78% loan-to-value ratio is reached due to advance payments by the borrower.