Mortgage guarantee insurance in the UK

By Brian Hall

IN ITS MOST basic form, mortgage guarantee insurance — sometimes also described as building society indemnity insurance — has been an integral part of mortgage lending activities in the UK for more than half a century. It has its roots in the need of building societies, in their early days, for the protection of a financial guarantee provided by a third party if they were to loan more than, typically, 80% of the value of a property.

There has always been a demand from purchasers of private properties to borrow a higher proportion of the value of the property, a demand which has grown substantially as more people have sought to buy their own homes, and the escalation in property prices has meant that the sum to be put into the property by the purchaser has increased dramatically. The provision of mortgage guarantee insurance has enabled lenders to meet that demand by supporting loans up to 95% and, on occasion, up to 100% of the value of the property.

While traditionally the UK mortgage market has been dominated by the building societies, in more recent years others have entered the market place providing mortgages on private properties. Initially these were the major clearing banks, and more recently other banks and specialist wholesale mortgage corporations. It has been natural for insurers to extend the provision of mortgage guarantee insurance to embrace these new lenders.

Mortgage guarantee insurance has been provided over the years by many of the major UK composite insurers, the financial security of the insurer being of paramount importance as cover is given on a 25 or 30 year non-cancellable basis and lenders have needed to be certain that, in the event of claims arising, the insurer will still be in business and operating in the UK.

Unlike the situation in many other European countries, loans to purchase properties in the UK have generally been to an individual in respect of the purchase of a specific property. Loans have typically been for a period of 25 to 30 years and have either been on a repayment basis or a standing basis.

In the former case the monthly payments by the borrower will comprise both interest and repayment of principal. In the latter case monthly payments represent the interest on the loan only, the repayment of principal being accomplished through, typically, an endowment insurance or private pension. Mortgage guarantee insurances have been provided in respect of all these forms of lending, the guarantee running for the full period of the loan.

Operation of mortgage guarantee insurance

Lenders will normally establish certain lending criteria in respect of mortgages on residential property, including the maximum percentage of purchase price or valuation, whichever is the lower, which they are prepared to lend. This ensures that reasonable security is available to the lender in the event of default by the borrower.

The arranging of mortgage guarantee insurance enables the lender to advance higher amounts than would be possible using their normal criteria but without increasing their risk. The guarantee therefore applies to the extra portion of the loan above the normal lending limit.

Premium for the mortgage guarantee insurance is charged to the borrower but with the guarantee operating for the protection of the lender. The intention of the cover is that in the event that the borrower defaults and the sale proceeds from the forced sale of the property are insufficient to cover the outstanding loan plus interest costs, the insurance company will pay the shortfall on the additional amount loaned, together with the interest attributable to the additional amount and all realisation costs.

Mortgage guarantee schemes usually operate on a delegated authority basis, with the lending institution having authority to bind risks within certain agreed criteria. The mortgagee is therefore the insured and it is they who are underwritten by the insurers.

An in-depth analysis is carried out and the lenders' mortgage business rated accordingly, depending upon factors such as:

- maximum loan to valuation,
- loan size, minimum and maximum,
- salary multiples on which loan will be based,
- target geographical areas,
- review of historical default/arrears data,
- quality of loans administration and arrears procedures.

A monthly bordereau system between lender and insurer helps to simplify the administration involved.

The premium charged by insurers is normally in the range of 3% to 10%, depending on the lending criteria adopted by the institution and the level of prudence adopted in their underwriting of mortgage applications. These rates are applied to the portion of the loan above the normal advance.

In order for there to be a claim on the mortgage guarantee insurance, the following sequence of events has to occur:

a) Default by the borrower.

b) Subsequent possession by the lender.

c) Resale of the property by the lender.

d) Shortfall with sales proceeds being insufficient to cover outstanding capital, accumulated interest plus the internal costs incurred.

Historically, the main causes of losses under mortgage guarantee insurance policies have included events such as:

short-term unemployment,
long-term unemployment,
change in job/income status,
marriage/relationship breakup,
rising interest rates,
rising credit commitment for borrowers.

The main element of claims paid has proved to be accumulated interest rather than shortfall in principal. This is primarily because repossession through the courts can take at least a year, with subsequent sale taking up to a further six months. Historically, the majority of claims under mortgage guarantee arrangements have not emerged until between three and five years into the life of the mortgages.

Lenders will also endeavour, wherever possible, to assist the borrower during times of short-term difficulty in order not to seek possession of the property. This is particularly true in the case of such factors as local industry strikes when forbearance can be quite significant. Where possession still has to be pursued arrears of interest will, of course, have been exacerbated.

Although mortgage guarantee insurance policies do contain a clause which gives the insurer the option to settle any claim before possession has actually taken place, in practice this is rarely invoked.

The current market for private mortgages in the UK

As already stated, more and more lenders have been entering the UK mortgage market. As at 31 December, 1987, total outstanding loans in the UK residential mortgage market were some £180 billion, with gross new lending during 1987 being approximately £58 billion. In recent years the market has grown consistently by about 20% per annum, fuelled by a number of factors including rising house prices, frequency of moving house and the availability of mortgage funds. Endowment-based loans currently represent over 75% of gross lending.

Increasing competition has led to a substantial amount of innovation in mortgage lending with the introduction of mortgages linked to LIBOR (the London inter-bank offered rate), fixed rate mortgages, low-start mortgages and the like. There has also been a growth in the provision of so-called non-status mortgages, including elements such as self certification of earnings.

Mortgage guarantee insurers have moved to accommodate all of these developments and to offer sensible support to the widest possible range of mortgage lending in the UK.

Increased competition has also produced some more worrying developments which have a direct impact upon the provision of mortgage guarantee insurance. These developments have been in the relaxation of lending criteria relating to the multiples of salary and proportions of valuation which are lent. One of the major factors contributing to the relaxation of the lending criteria, particularly with regard to the maximum percentage of valuation, is that of steady escalation in property values. Some lenders have taken a view on the likely value of the underlying asset rather than the ability of the borrower to service loan repayments.

Claims experience for mortgage guarantee insurance has deteriorated in recent years, leading to an increase in premium rates. This trend is likely to continue, particularly having regard to the current high interest rates and to the stabilising and, in some areas, drop in property values together with the highest average salary multiples ever seen. A return to more prudent lending policies is, therefore, important if an escalation in defaults, mortgage guarantee claims and thus premiums is to be avoided.

The last two years have also seen a dramatic development in the UK of a market in mortgage-backed securities. In these cases the income and capital repayments from a portfolio of UK private mortgages has been used to back the issue of an investment bond such as floating rate notes. Again some mortgage guarantee insurers have been swift to react to developments and to provide the necessary insurances to support such structures and release a source of funds for further mortgage lending.

Thus in the UK over very many years the insurance market has provided the necessary support to lenders to extend their lending practices and to facilitate house purchase. Insurers have been quick to respond to innovations and have provided a valuable 'smoothing' of the losses incurred by lenders during downturns in the mortgage market. This will continue into the future provided insurers can be satisfied that a prudent and sophisticated approach is being adopted by lenders and that they are not being forced into unreasonable lending practices through competition. ■

BRIAN HALL works for the Sun Alliance and London Insurance Company.