Mortgage Insurance for India

by Roger F. Blood

BACKGROUND AND OBJECTIVES

India's economy, including its housing finance sector, is undergoing rapid deregulation. Banking and insurance are on the threshold of moving from being owned and controlled by the centralized government to becoming decentralized, privately capitalized, risk-taking enterprises. Market forces already are driving significantly where and how financial capital flows, based on demand and priced according to risk.

Housing—officially a "favored" sector of India's controlled economy and therefore a recipient of subsidized annual credit allocations—has traditionally received such grossly inadequate amounts of capital that it could not even keep pace with population growth. With the advent of a freer market economy, housing faces a difficult transition. This transition harbors, however, unprecedented opportunities to realize real gains in both mortgage capital flows and physical production.

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On the one hand, decision-makers controlling the flow of capital will demand market rates of return, thereby squeezing traditional sources of affordable mortgage financing. Fiscal austerity and the drive to make India's economy more productive and internationally competitive also will leave less room for government officials and large employers to channel large subsidies into housing.

On the other hand, deregulation and a growing economy will open up huge new potential sources of mortgage capital and methods for channeling it into badly needed new housing production. Privately chartered insurance companies, banks, provident (pension) funds, and other institutional and individual investors will be seeking suitable investment-grade outlets for their growing volumes of investable funds. As 1996 begins, India's mortgage financings are already growing at an estimated annual rate of about 25%; even while most of the benefits of financial deregulation are still forthcoming.

To meet the needs of its burgeoning population, India must expand its supply of decent housing dramatically. The gap between available supply and need is currently estimated to exceed 35 million units and to be growing at about 1 million units per year. Mortgage financing sufficient to help eliminate even one-half of this gap (assuming an average cost of Rs. 2 lakhs per unit with 50% financed) translates to a potential five-year mortgage capital flow of about Rs. 20 million lahks. (One lakh equals 10,000 rupees or about US$2800.) Additional mortgage financing will be needed to upgrade the existing housing stock.

In recent years, India's specialized housing finance companies (HFCs) have been providing the bulk of institutional funding for home purchase—a national market estimated at over Rs. 100 billion. Serving as deposit institutions as well as mortgage lenders, HFCs somewhat resemble the United Kingdom's building societies or the savings and loan associations of an earlier era in the United States. Whether India successfully exploits financial deregulation to expand the delivery of needed mortgage capital and narrow the housing needs gap will depend in large part upon the evolution and performance of these HFCs. Because HFCs operate under the aegis of the National Housing Bank of India (NHB), NHB's leadership role is also crucial to the system's sound growth.

India's housing finance system today operates only in the context of a "primary" mortgage market. That is, all mortgage lenders—and most significantly all HFCs—keep in their own portfolio whatever mortgage loans they make. Consequently, with limited tools and flexibility, they must face the constant challenge and risk of assuring adequate sources of funds, matching mortgage and funding maturities, maintaining adequate asset-liability spreads, and holding sufficient capital reserves. All this in addition to the basic business of making good loans and keeping them current.

A number of nations with developed financial sectors have—with government help—created a secondary market for mortgage loans, whereby primary lenders can resolve the financial management dilemmas noted above by selling their mortgage loans to third party investors. Secondary market loan sales not only expand long-term funding flows, but also permit primary housing lenders to focus on their main mission: originating and servicing home mortgages.

Insuring mortgages against loss by reason of borrower default can expedite the workings of both a primary and a secondary mortgage market. With insurance, primary mortgage lenders can be induced to extend credit to additional potential home buyers with more permissive financing terms, thereby expanding the homebuying market. With insurance, secondary mortgage investors can be induced to purchase mortgage loans (either directly or in securitized form) that they would otherwise consider too risky or complex. In short, mortgage insurance serves to expand the flow of financial capital into housing, thereby stimulating home construction and improvement and increasing the rate of homeownership.

The India Housing Finance Expansion Project

India's existing mortgage finance system possesses certain key components that operate effectively, that are primed to thrive and grow under deregulation, and that could even serve as a model for other developing industrial nations. Key leaders, however, have recognized that the current housing finance system is not prepared to take full advantage of, nor operate soundly in, a substantially deregulated environment. The system as presently structured will not be able to close significantly the identified housing needs gap. Without major innovation and further development of the housing finance sector, India's large, emerging middle class will remain underhoused, while the problems of housing India's poorest will become even more vexing.

In 1992, the National Housing Bank of India and the U.S. Agency for International Development (USAID) commissioned a four-year project to upgrade the strength, breadth and capacity of India's housing finance system in an era of financial deregulation. The goals of this project, implemented under the auspices of Abt Associates, Inc., are to:

- Develop and expand India's private housing finance institutions.
- Increase domestic sources of mortgage funds.
- Establish joint pilot programs between NGOs (non-profit, nongovernmental organizations) and housing finance institutions to expand lending to households with below-median income.
- Assist the NHB in its role as an apex housing institution, including lender regulation and supervision and introduction of a secondary mortgage market.

This report evaluates the feasibility and potential usefulness of providing mortgage default insurance as a means of expanding housing affordability via increased availability of mortgage funding. This mortgage insurance study is one of the many components comprising the Housing Finance Expansion Project. Mortgage default insurance, as addressed in this report, touches to some degree most, if not all, of the larger project's goals as outlined above.

BASIC PRINCIPLES APPLICABLE TO MORTGAGE DEFAULT INSURANCE

Mortgage default insurance (MI) is in some respects unique among insurance lines. However, MI does share common insurance principles with other general lines, including:

- The transfer and spreading of defined risks so that individual assumptors of risk are not subject to ruinous random events.
- "The law of large numbers," or the pooling of a sufficient number of identified risks so that aggregate losses become manageable.
- Actuarial basis: defining, grouping, measuring, predicting and pricing the risks being assumed.
- Insurer solidity: defining the level and composition of policyholder reserves relative to risks assumed in order to assure the insurer's continued claims-paying and risk-taking capacity.
- Regulatory oversight: a framework of third-party (government) review to assure prudent management of assets and risks for the long-term benefit of insurance policyholders.
- Avoiding "adverse selection of risk," or policyholder behavior that causes the insurer to receive and accept risks that are excessive (relative to premiums collected) because the risks are not randomly selected.
- Avoiding "moral hazard," or behavior by the insurer and/or the policyholder after the insurance is issued that causes the loss incidence or severity to become greater than anticipated at the point of underwriting.

In addition, mortgage default insurance—regardless of its specific program features—exhibits the following special characteristics:

- *The risk assumed depends upon broad economic trends and public policies.* The type of public policy affecting mortgage insurance risk includes, but also goes beyond, national macroeconomic policies impacting income, employment, interest rates and housing demand. Policies at all levels of government involving taxation, the supply of buildable land, foreclosure laws, environmental laws, building regulations, etc. can raise or lower significantly home mortgage default patterns.

- *The critical MI risk is "catastrophic."* In other words, mortgage default risk is not limited to, nor is it primarily a product of, the "normal" risk that an individual homeowning household might experience in terms of financial adversity, resulting in foreclosure. Rather, a "catastrophic" risk refers to the widespread foreclosures that may occur as a result of economic depression at the regional or national level. For this reason, mortgage insurance may present the most significant example of catastrophic risk coverage of any insurance line.
- *The horizon of risk assumed under each individual MI policy is unusually long.* Home mortgages are long-term instruments—typically extending for at least 15 years. To serve its intended purpose, therefore, mortgage default insurance must be non-cancellable by the carrier. As a practical matter, the premium is typically fixed for the life of the policy at the outset, despite the likelihood of changing risk conditions during the life of a mortgage loan.
- *The unusual combination of credit and collateral risk.* The "event of loss" under a mortgage insurance policy is the borrower's failure to make required periodic repayments, in other words, to default. The risk of actual loss occurring also depends on the occurrence of a second event following borrower default, namely, the lender's inability to recover the full debt owed through disposition of the collateral property.
- Unlike most hazard insurance risks, inflation reduces, rather than increases, the risk of mortgage insurer loss.
- Establishing long-term catastrophic loss reserves is necessary to address the unique risks associated with the contingent probability of future economic depression. Consequently, MI is more capital-intensive than other insurance lines.
- Premium rates, while risk- and experience-based, lack the actuarial precision of most insurance lines. Premiums must be adequate to cover future economic catastrophe in addition to predicted frequencies and severities of default-related losses associated with a normal economic cycle.
- Moral hazard applicable to MI can arise from both the insured's underwriting behavior prior to placement of the risk and the insured's servicing (collections) behavior over the term of coverage.

CONDITIONS ESSENTIAL FOR MORTGAGE DEFAULT INSURANCE TO FUNCTION IN INDIA

Because mortgage default is a form of institutional financial guaranty, the establishment of a viable (i.e., long-term, self-sufficient) mortgage default insurance scheme in India will depend upon a range of pre-existing conditions in the financial services sector as well as in the larger national economic environment. These environmental preconditions would apply regardless of whether the source of MI sponsorship and ultimate risk assumption is government-based, private enterprise-based, or some combination of government and private sponsorship. A purely government guaranty would, of course, be less subject to both the financial disciplines of the marketplace and private institutional arrangements, while more dependent on the national treasury for its long-term viability.

Institutional Insurance Environment

To the extent that private sector capital supports a mortgage insurance scheme – with or without government backup – India will need an institutional insurance environment characterized by:

- An established framework (or enabling legislation) for the creation of an insuring entity authorized to write mortgage default insurance risk.
- A mechanism for establishing competent regulation and independent evaluation of the operations of the mortgage insuring entity – in particular, its long-term claims-paying capacity.
- The ability to mobilize sufficient risk capital to establish initial mortgage insurer policyholder reserves.

A mortgage insurance scheme operated entirely by a government agency would not, of course, depend upon the prior creation of an institutional insurance environment. Only enabling legislation, regulations and appropriations would be needed.

Institutional Mortgage Lending Environment

Beyond insurance-related prerequisites, a more extensive array of preconditions relating to the institutional mortgage lending environment, must be operative. These include:

- A defined need for a mortgage default insurance product. Lender recognition of the need is essential; borrower recognition would be desirable.
- A market potential sufficient for the principles of risk spreading and the "law of large numbers" to operate effectively.
- Institutional mortgage lenders whose financial staying power can be attested to by objective third parties.
- Mortgage lenders capable of performing consistently responsible loan underwriting.
- Mortgage lenders capable of performing consistently responsible loan servicing (e.g., collections and recovery).
- Mortgage lenders able and willing to conform to standardized underwriting definitions and criteria for purposes of securing mortgage default insurance.

- Lenders ability to secure reliable information on financial capacity and personal character of borrower-applicants.
- Lenders able and willing to assemble and efficiently convey to a mortgage insurer loan data essential for the purpose of evaluating and managing insured risk over time.
- Consistent and reliable methods for documenting the market value of homes.
- An effective system for establishing clear title to residential properties.
- An active home sales and resale market not unduly restricted by excessive transaction costs.
- A legal and political environment which, in the event of incurable mortgage default, will permit recovery of collateral property in a reasonable period of time and for a reasonable cost.

Additional Precautions

Finally, in addition to insuring and mortgage lending considerations, several functional preconditions are important to the viability of a prospective mortgage insurance undertaking:

- A mortgage default insurer must be able, over time, to charge premium rates adequate to cover actual and projected losses, thereby permitting profit margins sufficient to attract the additional capital to sustain new writing capacity. In this regard, mortgage experience data should be available that can demonstrate insurable levels of default frequency and loss severity. Alternatively, the nation's housing market and mortgage lending environment need to show sufficient stability to support rational pro forma claims and loss projections during the MI's startup phase. (Regarding the setting of premiums, the established rates need, in any event, to include a significant component for catastrophic loss coverage.)
- Launching a de novo mortgage insurer—regardless of sponsorship—requires identification of experienced persons with appropriate management and operating skills.
- Control of moral hazard requires practical methods of sharing risk with policyholders that are acceptable to mortgage lenders seeking insurance.
- The national economy must be sufficiently stable so as to render the likelihood of a catastrophic risk event extremely remote for the foreseeable future. Alternatively, a mechanism for shifting the catastrophic risk component to the central government must be available.

INSTITUTIONAL INSURANCE ENVIRONMENT: PROSPECTIVELY FAVORABLE FOR MORTGAGE INSURANCE

As of early 1996, India has no suitable insurance framework for the establishment of a mortgage default insurance vehicle. Continued deregulation of the nation's financial services sector, including the insurance function, appears virtually assured. However, the ending of the current government's insurance monopolies and the issuance of charters for new private insurance enterprises almost certainly will not occur until after the upcoming general elections. The likely pace of insurance deregulation thereafter remains uncertain and is subject to continuing political opposition, although some observers believe that general lines (property and casualty) will be permitted to privatize more rapidly than life insurance.

In the meantime, the current government insurance monopolies do not appear inclined to begin issuing government-sponsored mortgage default guaranties. Nor are they prepared to launch and manage a market-driven, actuarially sound mortgage insurance operation. The life insurance monopoly, LIC, owns a housing finance subsidiary (LICHF) that is just emerging from a difficult period of rapid portfolio growth and a fallout of very high loan defaults. With deregulation and the challenges of adjusting to market competition imminent, it appears unlikely that either LIC or GIC (India's general lines insurance monopoly) is positioned to engage in a new, highly specialized business of assuming catastrophic economic risks.

The prospective shape of India's deregulated insurance industry should offer an environment amenable to the establishment of a sound MI venture, either independently or in cooperation with an appropriate arm of the central government. The basic framework for a privatized insurance industry has been put forth by the Malhotra Committee. Key elements of the committee's proposals include:

- The granting of new charters, including charters for general lines (property and casualty).
- Minimum required startup capital of Rs.100 crores (about US$28 million).
- The establishment of a new insurance regulatory authority (IRA).
- The structuring of the privatized insurance sector to permit an inflow of international risk capital.

At least one established private investment rating agency, CRISL (Credit Rating Information Services of India, Limited), clearly possesses the core competencies, a sophisticated staff, and indicated incentives to rate the new general lines insurers, including, by implication, any such carrier that would choose to engage in writing mortgage default insurance. CRISL's rating activities demonstrate a strong orientation toward the financial services and real estate sectors, including closely related experience in rating HFCs, banks and builders. In anticipation of further financial services deregulation, CRISL management has given serious attention to the dynamics of the insurance business in general and financial guaranties in particular.

National Housing Bank executives have expressed their support for the establishment of a soundly conceived mortgage insurance entity in the context of financial services and insurance deregulation. While the NHB itself is not directly positioned within the insurance sector, the creation of MI capacity in India would depend upon active NHB collaboration with the appropriate insurance authorities.

A number of key HFC executives appear committed to active involvement in any private insurance sector that evolves. Life insurance and several general insurance lines are closely related to the residential mortgage business, so it will make strategic sense for HFCs to seek opportunities for growth and synergy via the privatizing insurance sector. Unless serious regulatory or other obstacles arise, the currently expressed interest in becoming users of mortgage default insurance on the part of HFC managers will almost certainly ripen into entrepreneurial initiatives to become MI providers when the opportunity materializes.

However India's housing finance system may eventually evolve (trends in other countries suggest movement away from specialized mortgage finance providers) in the near term, HFCs would be the central stakeholders in any form of mortgage default insurance. HFCs possess (at least collectively and prospectively) sufficient resources to capitalize one or more general lines insurers, including a possible writer of mortgage default insurance. The largest HFC—Housing Development Finance Corporation (HDFC)—has already undertaken specific actions to collaborate in the formation of a new insurance entity (not MI) in anticipation of insurance sector deregulation. HDFC has studied the mortgage insurance business, although it has no expressed plans to write mortgage default insurance.

Finally, because housing is still a priority sector within India's public policy goals for capital allocation and because options for direct capital allocation will inevitably recede as deregulation proceeds, it stands to reason that public policy will most likely support the establishment of a viable mortgage insurance function. MI's fundamental purpose, after all, is to induce the flow of capital into housing.

INSTITUTIONAL MORTGAGE LENDING ENVIRONMENT: GENERALLY FAVORABLE FOR MORTGAGE INSURANCE BUT WITH NOTABLE EXCEPTIONS

Most of the essential conditions conducive to the development of a sound mortgage insurance program in India already exist (outlined in the section above). Nevertheless, certain impediments to MI within the mortgage lending sphere warrant serious remedial attention. Most notably, the question of collateral recovery must be addressed before a cost-effective MI program is established.

Market Size and Diversity

On the positive side is India's sheer size. By any measure, India possesses the required scale for spreading insured mortgage risk: 3 million square kilometers of land (one-third the size of the U.S.); a population approaching 1 billion (of which a rapidly growing middle class currently estimated at 150 million comprises a potential homeowner base roughly equal to that of the U.S.); a federation of 25 separate states; and many diverse regional housing markets.

Lender Recognition of Need

There appears to be remarkable consensus among HFC managers regarding the need for, and the benefits to be derived from, the availability of mortgage default insurance.

These perceptions are not vague or ill-defined. The current posture of HFCs may be characterized as "underwriting to zero losses." Under the pressure of relatively narrow spreads and a rising cost of funds, HFC profitability appears highly dependent upon holding loan arrearages to an absolute minimum; actual write-offs have been almost nonexistent. The only temporary exception to this underwriting posture in recent years has been LICHF, which reportedly has experienced delinquency rates exceeding 10%. To date, even LICHF has avoided major loss write-offs.

A policy of "underwriting to zero losses" manifests in extremely conservative underwriting criteria. While rational in light of unforgiving HFC spreads, such an underwriting posture also significantly constrains lending volume. A lending program that consciously expects 2% to 3% of all loans made to result in default will result in approval of many more qualified applicants than a program that endeavors to eliminate all prospective defaulters. Mortgage default insurance is recognized as a vehicle that will induce mortgage lenders to move away from "underwriting to zero losses" and permit them to "expand the envelope" by serving applicants previously deemed unqualified. The incremental default risk would be insured, while the cost of assuming the added risk would be absorbed—either directly or indirectly—in the form of insurance premiums paid for by a greatly expanded population of qualified borrowers.

More specifically, HFCs agreed that mortgage insurance ought to be initially targeted to serve a significant class of borrowers who, in all respects except one, closely mirror the profile of borrowers currently served. The key change would be that MIs would induce lenders to reach prospective home purchasers at an earlier age—and therefore at an earlier stage of household formation and savings accumulation. Initially this is how mortgage insurance availability would contribute to expanded lending and homeownership.

For example, HFCs describe today's typical applicant as a married man in his late 30s—reflecting, by India's recent past standards, a continuing trend toward younger first-time home purchasers. Mortgage insurance availability should enable that typical applicant to qualify for a loan several years earlier than he could under prevailing underwriting standards. Instead of marrying and living with parents and possibly even young children for an extended number of years while increasing his income and saving to qualify for home financing, such an applicant would qualify for a given level of financing sooner with less income and less margin money.

With home prices often rising faster than incomes, the applicant could achieve homeownership sooner by assuming a somewhat higher initial payment burden (IIR) with the use of mortgage insurance (see illustration below). For this expanded, younger market segment, all other conservative underwriting parameters except the IIR could remain unchanged.

All HFC managers interviewed concurred that the incremental risk of default associated with moderately higher IIRs should be manageable with the support of a properly designed MI program. There appears to be no empirical data available from India or elsewhere suggesting otherwise.

An ancillary benefit of using mortgage insurance to enhance mortgage affordability, most interviewees observed, would be to reduce current tendencies to borrow margin money in the "informal" sector at very high rates and without the HFC's knowledge. Such a practice is conceded to be growing, is hard to detect, and is self-defeating in that the borrower assumes at the outset excessive payment burdens that, over time, destabilize the entire transaction in the event of even mild financial adversity during the loan's early years.

Other borrower groups identified by HFC managers as currently underserved, who might be reached through judicious use of mortgage insurance, include:

- Salaried applicants whose employers (and therefore whose incomes) are considered to be somewhat less stable than the incomes of borrowers employed by India's largest corporations and government agencies.
- Certain non-salaried applicants, e.g., self-employed professionals, whose demonstrated means of livelihood may be stable, but whose incomes and resources are difficult to document.

Prospective borrower's annual income	Rs. 36,000
monthly income	Rs. 3,000
Prospective home price	Rs.150,000
Margin money available (after loan origination cost)	Rs. 65,000
Required HFC financing	Rs. 85,000
Prospective monthly payment	Rs. 1,190
(15% rate, 15-yr term = 14 Rs./1,000 loan amount)	
Lenders IIR limit without mortgage insurance	35%
Lenders IIR limit with mortgage insurance	40%
Affordable monthly payment without mortgage insurance	Rs. 1,050
Affordable monthly payment with mortgage insurance	Rs. 1,200
Affordable loan amount without mortgage insurance	Rs. 75,000
Affordable loan amount with mortgage insurance	Rs. 85,700

In contrast to the use of MI to underwrite younger borrowers, the specific means for underwriting currently unserved self-employed individuals would require considerable effort to develop. Self-employed borrowers—both in India and internationally—present inherently higher underwriting risks and costs, which need to be carefully controlled. Likewise, the methods for evaluating income stability for borrowers who work for smaller or less-established employers would require cautious implementation.

In considering where and how mortgage default insurance might expand responsibly India's homeownership market, a fine line must be drawn by both MI users and providers. Any attempt to use mortgage default insurance as a substitute for prudent, thorough loan underwriting will eventually result in failure. Both users and providers of MI must be sophisticated enough to understand where and how the underwriting envelope can be expanded without assuming excessive or unintended risks.

Strength of Housing Lenders

A mortgage insurer's ability to manage risk and operate in an actuarially sound fashion depends on the competency and soundness of its policyholders, who, as lenders, create and select the risks to be insured. India's top-tier HFCs, all NHB-recognized, exhibit the requisite strength and staying power to qualify as mortgage insurance policyholders. In addition to NHB qualification, evidence of these strengths includes:

- Generally strong ratings from CRISL (The Credit Rating Information Services of India Limited).

- Public stockholders and, in many cases, large bank or other institutional affiliations.
- Operating track records of at least five years.

This study investigated whether a critical mass of solid capacity exists among the top tier of housing lenders for India to support the launching of a successful mortgage insurer. It concludes that such a critical mass does exist.

Housing Lenders' Underwriting Competence

Establishing the baseline credentials of a probable core group of lender-policyholders is necessary but not sufficient to determine the likely viability of mortgage insurance in India. Most, if not all, top-tier HFCs exhibit both the ability and commitment to underwrite home loans conservatively and thoroughly. Furthermore, additional second tier lenders—beginning with, but not necessarily limited to, the remaining group of about a dozen NHB-recognized lenders—may also be capable of originating and servicing mortgage loans that would meet the standards of a mortgage default insurer. Such determinations should be made case by case, following a successful startup period during which participation would be limited to top-tier HFC lenders.

Although the preponderance of HFC underwriting observations are positive, several significant weaknesses would also stand out when viewed by a mortgage insurance risk manager considering approval of a lender as a new insurance policyholder:

- Underwriting checks performed tend to be insufficiently documented by some HFCs.
- Underwriting is heavily tilted toward borrower repayment over collateral value—due in large part to India's presently unworkable foreclosure laws.
- HFCs appear overconfident that home values will continue to rise indefinitely. This attitude could prove hazardous in the future because it may prevent HFCs from recognizing and reacting quickly to market warnings of a sudden decline in home values.
- The concept of quality control (i.e., post-underwriting audit of recent loans to determine compliance with established underwriting policies and document requirements) does not appear to be well developed.
- Verification that margin money claimed by the borrower is not borrowed from a third party may need to be conducted more aggressively to assure that an equity cushion sufficient to control risk is present in all cases as claimed.

A mortgage insurer, in order to operate efficiently and charge affordable premiums, is not well positioned to re-underwrite every individual loan that lender-policyholders seek to insure. At best, the MI will be able to perform a case-by-case underwriting review and a periodic in-depth audit. MI reliance on the integrity of the HFC's underwriting is critical. In light of this dependency, the underwriting weaknesses identified above must be considered serious. However, when measured against the positive findings, these shortcomings are neither so severe nor so incorrigible as to invalidate the overall finding that HFC underwriting practices should protect sufficiently the risk exposure transferred by the HFC to a third party mortgage insurer.

A distinction needs to be drawn between underwriting standards and underwriting documentation. Regarding HFC underwriting standards, lenders seeking to avail themselves of default insurance would need to adapt externally imposed MI underwriting standards, which would inevitably involve modifications to existing standards—but only for those loans requiring MI coverage. A review of sample underwriting criteria currently applied by HFCs suggests that such adaptation should not be difficult.

Lack of standardized underwriting documentation need not be considered an underwriting weakness of the HFCs. Variations among HFCs with regard to loan documentation presents an obstacle to the goal of establishing a secondary mortgage market and mortgage securitization. For a mortgage insurer, however, the absence of standard documentation is more an inconvenience and a drag on efficient underwriting review than it is a risk management issue. Mortgage insurers in the U.S. functioned quite well for over a decade before the advent of a national secondary market mandated uniform loan documentation. Mortgage insurers in other countries, such as Australia, New Zealand and Canada, operate successfully today without standardized lender documentation.

Housing Lenders' Servicing Competence

The HFCs that provide the bulk of the nation's financing for home purchases also exhibit effective collection practices and results. In particular:

- Delinquent borrowers are contacted early and are visited personally by the lender after the second or third overdue installment.
- Regional loan officers (appraisers) are generally responsible for handling collections on their own delinquent loans.
- Peer pressure—apparently much stronger in India than in many other areas—is effectively brought to bear on delinquent borrowers. The system of loan guarantors appears to be fulfilling its intended function, when defaults occur.

Delinquency reporting methods need improvement and standardization. Even at present, however, a mortgage insurer seeking to qualify potential master policyholders among prospective HFCs would have little difficulty making an informed judgment about loan servicing capability and performance.

Property Valuations

A mortgage insurer commencing operations in India would probably seek to strengthen methods currently employed by lenders to establish and document the market (i.e., resale) value of properties being offered as loan security. Such changes may provoke debate, as the current system is thorough, professional and has worked well to date. The current cost-based system of performing residential valuations does not rely primarily on sales and market data. The weakness of such a system is not readily apparent and may not become so for some time, i.e., until India experiences a period of widespread home price deflation.

The current lack of emphasis on collateral recovery in the event of borrower default—a natural outgrowth of the nation's unworkable foreclosure laws—may also impede an early move toward more comprehensive, and therefore more costly, property valuations.

The need to strengthen the collateral valuation side of underwriting as a prerequisite to a system of insured home mortgage lending is offset somewhat by the likelihood that even increased loan amounts achievable with the use of MI will not bring real loan-to-value ratios above 75% in most cases. Consequently, tolerable margins of error on valuations may be greater in India than in the U.S. and elsewhere, where the loan-to-value ratios of insured home loans are typically 90% or higher.

Risk Management Data

Some HFCs currently appear to possess information and reporting systems capable of providing a prospective mortgage insurer with essential underwriting and risk management data. Such data would include loan level information on the insured borrower, and the property, key characteristics of the loan itself, and meaningful aggregated information on the status and performance of the lenders insured loan portfolio.

HFCs not currently possessing such capabilities, if sufficiently motivated by the benefits accompanying access to MI, should be able to develop workable data capture and reporting systems without undue time or expense.

Ownership and Transfer of Property Title and Liens

A system for establishing clear title to mortgaged properties—essential to the functioning of a bona fide mortgage insurer— appears to exist in a workable, though not particularly efficient, form. The transactions costs relating to transfer of title and recording of liens, however, are excessive in most states. Such levies (e.g., stamp tax rates well over 10%) should not, in and of themselves, render MI infeasible. Maintaining such levies, however, will raise the cost of mortgage default insurance, because they will increase significantly the loss severity of every insurance claim paid —the direct result of excessive collateral recovery costs and depressed net realizable values on property resales.

Unworkable Foreclosure System

Residential mortgage foreclosures, when pursued to execution, are reported to require typically more than 10 years. Successful foreclosure completion, furthermore, is not guaranteed, even when established legal procedures are followed meticulously. Because mortgage default insurance implies some level of reliance on pledged collateral in addition to borrower credit, the absence in India of a reliable default remedy in the form of foreclosure and recovery presents the greatest single impediment to the development of a successful mortgage insurance scheme.

Various methods may be employed to circumvent the lenders'—and prospectively the insurers'—inability to recover the collateral property of a defaulting borrower. Such methods clearly strengthen the ability to alleviate or cure delinquencies. They do not, however, address the incurable cases—the ones that cause the largest losses.

International standards for traditional MI product design require lender repossession and tender of the collateral property as a condition of perfecting a mortgage insurance claim. Even so-called cash flow guaranties in other nations' mortgage default systems typically rely upon the ultimate recoverability of the underlying property. In most instances this process requires one year or less.

It is, of course, possible to change the prevailing concept of mortgage default insurance and to design an alternative program to fit the particular situation in India, where it is presently nearly impossible to recover collateral properties. The critical question then would shift from theoretical product design to overall cost and feasibility. Suffice to say here that an open-ended MI claims liability without a reasonable prospect of salvage (collateral recovery) translates directly into significantly higher premium rates. The added charges would, in turn, raise cost-benefit and market acceptance issues.

Foreclosure reforms proposed to date, involving specially empowered foreclosure tribunals, face an uncertain future in two respects: (1) political uncertainties regarding whether such laws will pass, although prospects seem more promising for current proposals than for previous ones; and (2) even should the necessary foreclosure reforms be legislated, skepticism remains that meaningful implementation at the local level will be thwarted, particularly when it comes to recovery of physical possession of the property following recovery of legal title.

FINDINGS AND RECOMMENDATIONS

Both the retail mortgage lending sector and the general insurance environment appear to be conducive in the relative near term—though not immediately—to the development of a viable mortgage insurance program.

Expanded Lending and Homeownership

As India's financial markets deregulate and privatize, mortgage default insurance should be able to evolve as a useful adjunct to the nation's home mortgage financing system. Initially, mortgage insurance can help expand the universe of potential first-time home buyers who qualify for financing ("primary market"). Subsequently, mortgage insurance can help increase the flow of institutional capital into home mortgages via mortgage-backed investment instruments ("secondary market").

By inducing moderately relaxed underwriting limits, mortgage insurance should enable the leading HFCs to make homeownership possible for 10,000 or more additional below-median-income households nationwide each year. Once mortgage insurance becomes an accepted part of the market for home financing, the number of additional first-time buyers reached through MI should grow at least as rapidly as the overall market. Of course, even such modest benefits depend upon HFCs having adequate funding sources from which to increase lending value by the desired amounts.

Mortgage insurance should also help approved lenders to reach other currently unserved and underserved segments of the market. Two such clearly identifiable sectors are those self-employed persons who, with better income documentation, could qualify, and salaried persons whose source of income is currently viewed by lenders as insufficiently stable. There is at present, however, no practical way to gauge the probable size or share of this potential market that can feasibly be underwritten by using MI as a risk management tool.

Foreclosure System Reforms

As a form of credit enhancement that guarantees repayment of a loan collateralized by housing, mortgage default insurance relies on the ability to recover the pledged collateral in the event of default. The emergence of mortgage insurance in India in the near term will be seriously impeded—though not necessarily prevented—in the absence of legal and political reforms that result in a working foreclosure system.

Efforts to launch a program of mortgage insurance should not be deferred because of problems with the current, dysfunctional foreclosure system. At worst, any MI product offered and accepted in the short run will suffer from excessive costs attributable to the lender's and insurer's inability to mitigate claims losses through collateral recovery and resale. If even a single jurisdiction were to enact and implement genuine foreclosure reforms, the resultant reduced costs of mortgage insurance and financing will translate into expanded homeownership opportunities. Should such benefits then become apparent to other jurisdictions, further reforms may follow.

These observations also apply to the very high transactions costs attributable to property transfer fees and documentation registration costs. The effect of reduced transaction costs on the cost and feasibility of mortgage insurance would be far less than the benefits of foreclosure reforms, however.

The tentative finding that mortgage insurance should be feasible to implement in the face of current foreclosure obstacles and excessive transaction costs needs to be tested further in the emerging marketplace. While the potential benefits of mortgage insurance are recognized by thoughtful market participants, there remains the possibility that a self-sustaining mortgage insurance program would have to be priced so high that borrowers and lenders would judge the MI's indicated benefits to be not worth its required cost. In this instance, one of two eventual positive outcomes might still emerge:

1. The recognized public policy benefits associated with increased housing affordability might result in some form of government financial support for an early MI launching, pending subsequent resolution of difficulties relating to foreclosure laws and transaction costs.
2. MI implementation might be deferred until evolving market forces bring sufficient pressures to bear—possibly one state at a time—producing foreclosure and transaction cost reforms.

Pricing and Risk

In the absence of reliable domestic experience data relating to home mortgage default frequency and loss severity, initial pricing of a new MI product in India should be based on conservative estimates of claims incidence and severity. Such conservatism will be limited by "what the markets will bear" in terms of offered premium rates, particularly because premiums will be borrower-paid—either directly or indirectly—while increased borrower affordability is an essential feature of the product. If this balance is not properly cast, the MI will fail either from excessive premium rates or excessive losses.

Mortgage default insurance deserves serious consideration for early implementation in India to increase housing affordability and flow of mortgage capital. Obstacles identified in this report may deter a mortgage insurer from operating efficiently in the near term and raise its cost considerably. Over time, foreclosure reforms and other transaction cost reductions can permit mortgage insurance to fulfill its intended purposes far more effectively and at a much lower cost.