Head in the Sand

'Un-Insurance' is No Business Solution for Mortgage Insurance Companies Facing Bad Risks

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Since things are tough all over, some businesses are turning to innovative ideas to shore up their bottom lines. One of the most innovative is the mortgage insurance industry's effort to deal with an unexpectedly large problem: the risks and liabilities that they face today due to past sales of private mortgage insurance (PMI) policies.

The innovative idea? Un-ring the bell or — in this case — un-sell the policies. And many insurance companies have decided to do just that.

In December, Moody's Investors Service announced that mortgage insurance rescission rates have skyrocketed to about 20%–25%, up from their historical average of 7%.

In terms of dollars, the cost is in the billions. Moody's estimates that approximately $6 billion of claims were rescinded in 2008 and 2009. As many as $10 billion in claims may be rescinded before this cycle is through.

Even though these mortgage insurance policies were purchased and paid for years ago, were required by law in many circumstances, and were integral to the lenders' decisions to sell the mortgages in the first place, many insurance companies seem to perceive rescission as an option for mitigating risks — an alternative to that other "option" of paying the claims.

In the eyes of the lenders, it's like rewriting history. And the lenders are not buying it. In December two divisions of Bank of America filed a complaint in state court in California against Mortgage Guaranty Insurance Corp., seeking declaratory relief against its rescission practices.

The insurance companies see things differently. Like unhappy spouses seeking to annul their marriages, they say that the recent wave of policy rescissions reflects their sudden discovery of extensive amounts of fraud and misrepresentation by policyholders who purchased the insurance policies.

Certainly, this explanation may justify some of the rescissions and denials. But the context of certain corporate announcements and the timing of these "sudden discoveries" cast doubt upon whether fraud and misrepresentation justifies most — or all — of them.

For example, in a press release announcing substantial losses in the fourth quarter of 2008, Genworth Financial stated that it reduced its total loss exposure by $84 million by rescinding policies and denying claims. Chillingly, it made the announcement in connection with its report on the corporation's overall liquidity, including the steps it was taking "to further reduce risk in response to ongoing difficult market conditions."

During that same quarter, Fitch Ratings apparently took such announcements into account in assessing whether to downgrade the ratings of three mortgage insurance companies, including Genworth. In October, Fitch announced that it was

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downgrading them regardless, but it identified the increase in rescissions and denials as a favorable part of the mortgage insurance industry's "loss mitigation" strategy:

> Offsetting increased losses, however, Fitch notes a meaningful increase in claim denial (or rescission) activity across the industry relating to fraudulent loans. Fitch believes that rescission activity will play a significant role in the MI industry's loss mitigation strategy over the short term, particularly with regard to the 2007 vintage and Alt-A exposure, allowing to varying degrees some control over the amount and timing of losses.

Policyholders, state insurance departments and courts should take every action necessary to fight disproportionate surges in PMI rescission attempts and make clear to mortgage insurance companies that these tactics will not be allowed.

Private Mortgage Insurance — Myth or Reality

To insurance companies, private mortgage insurance, or PMI, is a tool to help borrowers buy a home when they cannot make a down payment of 20%. According to an insurer's marketing materials, PMI allows these borrowers to "responsibly buy a home years sooner," makes the dream of homeownership possible, and leads to "sooner, safer, and smarter homeownership."

To lenders, PMI is supposed to mean that they can sleep at night. PMI simultaneously allows loans to buyers who cannot make a 20% down payment and protects the lenders from situations where borrowers do not make payments on their loan. Lenders rely on PMI to make loans safer and more secure.

Like most insurance policies, PMI is underwritten and priced based upon the risk that is perceived to exist at the time that the insurance policy is sold, as MGIC underwriting guidelines specify. Risk is the essence of the insurance business; whenever insurance companies sell insurance policies and collect premiums, they are purchasing the risk of future obligations to pay.

The entire industry would be eviscerated if insurance companies were allowed to look back

months or even years after the PMI policy is priced and sold and try to rewrite the terms of the insurance policy based upon an actual or perceived increase in risk. If this type of "look-back" were allowed, policyholders would not be purchasing protection against possible losses when they buy insurance policies. They would be purchasing absolutely nothing at all.

A Decline in Property Value is Not a 'Breach' by the Lender

No mortgage insurer could seriously contend that a decline in property values constitutes a breach of contract that justifies rescission. A breach of contract is, by definition, a "failure, without legal excuse, to perform any promise which forms the whole or part of a contract." Uncertainty about a property's value is an inherent risk in the mortgage industry. No lender could ever, or would ever, "promise" that the value of a property will not decline over the period of the loan. Since guaranteeing market conditions is not a promise that the lender

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makes as part of a mortgage insurance policy, a decrease in property values is not a breach of the lender's obligations. It also is not grounds for the mortgage insurer to cry "fraud."

Mistake About Property Values Does Not Justify Rescission

Rescission is sometimes warranted where the parties make a mutual mistake regarding a key term of a contract. More specifically,

1. Where a mistake of both parties at the time a contract was made as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake.

2. In determining whether the mistake has a material effect on the agreed exchange of performances, account is taken of any relief by way of reformation, restitution, or otherwise (Restatement of [Second] of Contracts § 152 [1981]).

However, rescission is not universally permitted even where there is a mutual mistake by the parties. In fact, rescission "is only appropriate where a mistake of both parties has such a material effect on the agreed exchange of performances as to upset the very basis for the contract." Additionally, the mistake must be "as to a basic assumption on which both parties made the contract."

Mistakes as to assumed market conditions — and the changes in market conditions — are not "basic assumptions" which, if wrong, might make the contract voidable. It is well-established that "just as shifts in market conditions or financial ability do not effect discharge under the rules governing impracticability, mistakes as to market conditions or financial ability do not justify avoidance under the rules governing mistake" (Restatement of [Second] of Contracts § 152 [1981]).

Getting Hit From All Sides — Look Closely at Attempts to Rescind Policies

Lenders are getting hit from all sides. Lower property values, increased incidences of borrower defaults and attempts to rescind private mortgage insurance, are among the parade of horribles that they are facing.

Certainly, mortgage insurance companies are facing horribles as well. No one is contending otherwise. But, like everyone else affected by the mortgage crisis, mortgage insurance companies should be held accountable for the consequences of their decisions. They should not be allowed to "un-sell" their insurance policies and pass the risks straight back to their policyholders. They are not entitled, at this late date, simply to "change their minds." ▲