

The Mortgage Indemnity Insurance Market in the United Kingdom

by Mark Boléat

INTRODUCTION

For much of the post-war period, the United Kingdom housing market was characterized by a steady increase in owner-occupation. People purchased their first houses at a very early age, at which time they had had little opportunity to accumulate savings. Lenders sought additional security which normally was in the form of an indemnity policy by an insurance company for which a single premium was paid by the borrower. The system worked well as long as the housing market continued to thrive and house prices increased. However, in the late 1980s and early 1990s there was a severe downturn in the housing market which caused major losses to the mortgage indemnity insurers. Subsequently, there has been a radical restructuring of the mortgage indemnity insurance market. This article briefly analyses these trends.

Mark Boléat is Director General of the Association of British Insurers. Until 1993 he was Director General of the Building Societies Association and the Council of Mortgage Lenders. Between 1986 and 1989 he also was Secretary-General of the International Union of Housing Finance Institutions, and he was the founding editor of the journal, *Housing Finance International*.

THE TRADITIONAL U.K. HOUSING AND MORTGAGE MARKETS

At the end of the second world war, fewer than one-third of the houses in Britain were owner-occupied; the majority of the housing stock was in the private rental sector. Since then, there has been an inexorable decline in the private rental sector, largely because of rent controls and security-of-tenure legislation. This has been matched by a steady increase in owner-occupation and, until 1979, also an increase in the proportion of houses rented from local authorities. The election of a Conservative government in 1979 marked the end of the rise of council housing, with new building by local authorities virtually ceasing and many existing council homes being sold to their tenants. Owner-occupation, which stood at 29% of all dwellings in 1950, rose to 42% in 1960, 50% in 1970, 56% in 1980 and 67% in 1990.

While the level of homeownership in Britain is not unusual by international standards, the rate of increase in the post-war period is. In America, for example, the homeownership rate increased only modestly from 55% in 1950 to 64% in 1990. Similarly, in Australia, the homeownership rate was over 50% by 1947, since when it has increased to around 70%. In Canada, the homeownership rate increased by little more than two percentage points in the 1970s and 1980s. In Japan, the homeownership rate actually declined between 1963 and 1988. In Europe, France shows the

largest increase in owner-occupation but then only from 41% in 1962 to 54% in 1990.

The increase in homeownership took place in an inflationary environment and was spurred on not just by the lack of choice but also by tax incentives. The general philosophy was that one should get on the housing ladder as soon as possible with the largest mortgage that one could afford, and to move within a relatively short time to capitalize on the effects of inflation.

Because for most young people rented housing was simply not available, the housing market had to accommodate first-time buyers who were young and had little savings. In 1991, 36% of households with a head of household aged under 25 were owner-occupiers, a far higher proportion than in other countries.

Most first-time buyers need high percentage loans, typically well over 80% of valuation. The mortgage lenders were willing to provide these loans, safe in the knowledge that the default rate was minuscule and that there was seemingly an economic law which provided that house prices never fell. Even mortgage lenders, however, required some additional security with such high percentage loans. This took the form of mortgage indemnity insurance.

THE TRADITIONAL MORTGAGE INDEMNITY INSURANCE MARKET

Mortgage indemnity insurance policies were first introduced in the 1920s. There was little

product development, however, until the crisis of the late 1980s. Indeed, until 1980 the policy wording generally used was agreed to at the national level between the relevant trade associations and, also until that time, there was an agreed scale of charges which almost all lenders and insurers used.

A mortgage indemnity insurance policy is an arrangement between an insurance company and a lender who has loaned money to a borrower on the security of a mortgage of a property owned by the borrower. Under the terms of the policy, the insurer undertakes, subject to compliance with certain conditions, that if the lender exercises its power of sale over the mortgaged property and the borrower fails to repay any difference between the proceeds of sale and the outstanding debt, then the insurer will pay to the lender the amount equal to the deficiency or a specified part of that amount. For example, if the house was purchased for £50,000 with a 100% mortgage when the lender's normal limit was 80%, then the insurer was in effect agreeing to indemnify the lender for any losses up to £10,000. Claims were thought to be very unlikely because for a claim to be made, first, the borrower had to default; second, the borrower would not be able to sell his property at an amount sufficient to cover the mortgage debt; third, the lender, having taken possession, also could not recover the mortgage debt by selling the property; and, finally, the borrower could not be persuaded to make good the deficiency.

Lenders typically arranged all of their mortgage indemnity insurance with a single insurer under a block policy. There was in effect no underwriting of individual risks, although lenders did require loans to be within specified overall lending criteria. It is fair to say that most mortgage indemnity insurance was written on the back of large and very profitable household policies. Unlike some other countries, there were no specialist monoline mortgage indemnity insurers; rather, the bulk of the busi-

ness was taken by four major composite insurers, all of which had large household accounts. Table 1 shows the market shares of the four largest participants in the market between 1987 and 1993.

Table 1. Participants in mortgage indemnity insurance market 1987-93

<i>Insurer</i>	<i>Gross Premiums £m</i>	<i>Percentage Total</i>
Sun Alliance	351	28
Royal	304	24
Eagle Star	200	16
Legal & General	149	12
Others	250	20
Total	1,255	100

Source: Eagle Star

It is estimated that between 1946 and 1961 the business recorded a loss ratio (loss to premium income) of just 33%, with a commission ratio being also 33%. Between 1983 and 1986, the commission ratio (also to premium income) had risen to 40% but the loss ratio had risen to 70%.

THE MARKET IN TURMOIL: 1988-1994

In each year in the 1980s house prices increased and in six of the years the annual rate of increase was in double figures. There was a very strong boom in the latter part of the 1980s, fueled by a rapidly growing economy, tax cuts and falling interest rates. Like previous booms, this boom went too far, with house prices rising to an unsustainable relationship with earnings.

The downturn was not unexpected, but it was for a combination of reasons far more severe than previous downturns. The most important

of these were that the recession was much deeper than previous recessions; and, second, the downturn coincided with rapidly falling inflation, which meant that the adjustment in real house prices had to come not through a combination of stable nominal house prices and inflation but rather through falling nominal house prices. The fall varied considerably from region to region. It was around 30% in the South of England, between 10-20% in Wales and most of the North of England, and under 10% in the far North of England, Northern Ireland and Scotland.

The combination of rising interest rates, rising unemployment and falling house prices led to an unprecedented increase in mortgage arrears and possessions. The number of properties taken into possession increased from a low point of 16,000 in 1989 to 75,000 in 1991 with a corresponding increase in the number of loans more than six months in arrears to well over 300,000.

Mortgage lenders began to incur substantial losses on their mortgage portfolios and, of course, where appropriate, they made claims on their mortgage indemnity policies. No precise figures are available for the total underwriting losses, but the consensus is that they probably exceeded £6 billion between 1991 and 1996. This far exceeded the premium income and associated interest that had been earned on the account over many years. Table 2 illustrates how the market deteriorated between 1987 and 1993.

Not surprisingly, there were contractual disputes between mortgage lenders and insurers. Much of the business had been conducted relatively informally with contract terms often being vague and based more on custom and practice rather than written statements. Some disputes had to be resolved in the courts, although generally insurers and lenders managed to reach agreement without recourse to law.

Table 2. Mortgage Indemnity Insurance Market 1987–1993

Year	Gross Premiums £m	Commission £m	Net Premiums £m	Incurred Claims £m
1987	112	34	788	27
1988	176	53	123	40
1989	160	48	112	49
1990	187	56	131	156
1991	208	62	146	509
1992	237	64	173	844
1993	174	—	174	1,193

Source: Eagle Star

THE NEW MARKET

Inevitably, the prevailing mortgage indemnity insurance market could not continue. The extent of claims was such as not only to threaten the continued availability of mortgage indemnity insurance but also the commercial viability of the companies providing that insurance. The insurers worked collectively to agree on new policy terms. In notifying these arrangements to the European Commission, the insurers identified five weaknesses with the prevailing arrangements:

1. A failure on the part of insurers to agree with lenders and/or to police the observance of appropriate lending criteria.
2. The absence of an upper limit on the insurers' liabilities.
3. The absence of any certainty of risk participation by the lender.
4. Faulty policy wordings leaving the insurer, lender and, in some cases, the borrower, uncertain as to the intended effect of the policies.
5. A failure on the part of insurers to ensure that claims could be avoided under policies in circumstances where the lenders' or

borrowers' conduct could be demonstrated to have been fraudulent.

The insurers set out five new principles for the continuation of the business:

1. Mortgage indemnity insurance for residential property would relate only to mortgage advances which fell within the lending criteria of the lender, such criteria having been agreed to by the insurer.
2. The maximum indemnity provided for each insured mortgage should be limited to the amount by which the total mortgage loan exceeds the normal lending limit of the lender. Previously, the insurer had not only borne the loss of capital value but also the accumulation of outstanding interest payments and the costs which had been incurred.
3. The lender would retain for his own account a material proportion of the risk relating to the excess of the actual advance over the normal advance. The loss sharing is stipulated in the agreement with the lender's share at least 20%.
4. The definition of the costs and proceeds to be applied in the calculation of a claim

within the agreed indemnity limit would be clearly defined with the insurer having clear rights to require the lender to pursue the recovery of the deficiency from the mortgagor.

5. Regarding individual claims, fraudulent behavior on the part of the borrower or the lender, or any agent of either of them, concerning any element of the mortgage, would enable the claim to be resisted.

At this time a new name for the product—Domestic Mortgage insurance—came into being, replacing the old Mortgage Indemnity Guarantee, although in practice the product continues to be known by a variety of names.

Not surprisingly, the introduction of the new terms was resisted by the lenders, and there was a period of difficult negotiations. At the time there were large amounts of disputed claims, but the lenders were anxious that the insurers remain in the market. Some of the insurers were rumored to want to get out of the market entirely and stayed in it only to protect their household business.

Some lenders decided that this was a risk which they could themselves take on, and they established captives for that purpose, although generally reinsuring the risks. The situation was ready for new entrants into the market, unencumbered by the problems of the past. A major new arrival duly arrived in the shape of Gemico, part of the GE Capital Group, which has now acquired a significant proportion of the total business. GAN, the French-owned company, and some Lloyd's syndicates are also in the market.

The changing nature of the market was usefully described by Nicholas Millard, Head of Financial Risks at Special Risk Services. In an article in *Mortgage Insurance News*, February 1995, Mr. Millard noted a move away from one product, that is, the new standard domestic mortgage indemnity contract with a

flat pricing structure. He identified five products currently on the market:

1. *Domestic Mortgage Insurance*—the most common product, although this position was not expected to last.
2. *Excess of Loss*—which was becoming more common.
3. *Catastrophe Reinsurance*—similar in nature to excess of loss but handled in a different way. This product is particularly suitable where lenders establish their own captive insurers.
4. *Lloyd's Contract*—which gives a broad cover without quite the same restrictions as those in the new domestic mortgage indemnity contract. However, capacity in the Lloyd's market is limited.
5. *American Insurers*—who are relatively new to the market.

Mr. Millard predicted that the days of domestic mortgage insurance would be numbered and he saw the American underwriters taking a higher mortgage share.

There is a view in the insurance industry that there is still an imbalance between the relative risk/reward ratios for insurers and lenders. Insurers are enabling lenders to trade in highly profitable sectors of the market at a reduced risk. This produces profits for the lenders; but there is a view within the insurance industry that not enough of the reward is going to insurers who are taking a substantial part of the risk. There is a question as to whether insurers should be providing ground-up cover. The major risk is a catastrophe one and is influenced largely by macro-economic factors. This all points to an acceleration of a move in the market towards catastrophe-type reinsurance arrangements, with the lender taking the ground-up risk themselves.

PUBLIC POLICY ISSUES

The substantial losses incurred by mortgage lenders and their insurers have naturally been of great concern within the industry. But, of course, public and political concern has been more with the plight of homeowners who, in many cases through no fault of their own, found themselves with an asset worth substantially less than their mortgage and mortgage repayments which they were unable to afford. Lenders and insurers generally reacted sympathetically and pragmatically to this position. A borrower paying, say, 70% of the amount due on the mortgage, where the value of the house was substantially less than the amount of the mortgage, could be seen almost as doing the lender and insurer a favor. If he stopped paying his mortgage, by the time the lender took possession the outstanding debt could be much higher. The general policy was that where borrowers were paying a reasonable amount, lenders did not seek to take possession. Many borrowers, however, faced with a combination of negative equity and inability to afford the mortgage repayments, saw possession as a solution rather than a problem.

The insurers had the right to pursue the borrower for the debt owing, although in practice this remedy was seldom taken, largely because the borrowers did not have any money. Where, however, the borrowers were in the category of "won't pay" rather than "can't pay," they were pursued. This led to the emergence of a rather strange problem which was allowed to run in the press for quite some time before it was satisfactorily resolved.

There had never been any doubt in the minds of either mortgage lenders or their insurers that the purpose of mortgage indemnity insurance was to protect the lender. Nothing had ever been said to borrowers which suggested that they derived any benefit other than being able to obtain a loan which otherwise they could not have obtained.

However, one or two enterprising financial intermediaries, aided in some cases by rather gullible journalists, decided to pursue the argument that as the borrower had paid for the insurance, then surely he was entitled to benefit directly from it. One company, Union Finance, again with the help of the press, argued that it had helped many people out of their negative equity problem simply through surrendering the keys.

Lenders and insurers were somewhat slow to react to this problem, hindered perhaps by the absence of adequate documentation. Eventually, however, with the help of some court cases and the release by insurers of all of the documentation, the notion that borrowers could benefit directly was satisfactorily disposed of.

There was a recognition, however, that borrowers perhaps needed to know more about the nature of mortgage indemnity insurance. Accordingly, the Council of Mortgage Lenders, the representative body for the mortgage lending industry, after consulting the Association of British Insurers and other relevant parties, produced a borrower's guide to mortgage indemnity which is reproduced in full in the accompanying panel.

Now that any legal doubts have been firmly removed, it is quite probable that the recovery of debts will be pursued more vigorously by both insurers and lenders. There is still a need for borrowers generally to understand that if they borrow money, that money must be repaid at some time and that this is their responsibility even if circumstances change. The borrower's guide should help inform the public that there is still a substantial way to go.

CONCLUSION

The mortgage indemnity insurance market is still in a state of considerable change. The major problems of the early 1990s have now

largely been resolved with lenders and insurers having reached an accommodation about outstanding claims. A new business is being developed based on much sounder underwriting criteria, where the risk is more

reasonably shared between the borrower, the lender and the insurer. The market is no longer the preserve of a single basic product offered by large composite insurers on the back of their household policies. Rather, there is a

variety of products provided by a variety of insurers, including those traditionally in the market, but also Lloyd's underwriters and monoline American insurers.

**MORTGAGE INDEMNITY:
A BORROWER'S GUIDE
Summary**

- Mortgage indemnity may be taken out by your lender as additional security for itself.
- Mortgage indemnity does not cover you.
- You must repay all money owed under your mortgage whether your lender makes a mortgage indemnity claim or not.

What Is Mortgage Indemnity?

Mortgage indemnity is insurance which your lender may take out for its protection in case, at some future stage, you fall significantly behind with your mortgage payments and your lender has to repossess your property and sell it. If the property is sold for less than the amount of your outstanding mortgage, your lender can claim on the mortgage indemnity to recover some (or all) of its loss. The basic security for the mortgage is your property. The mortgage indemnity, therefore, acts as a form of **additional security** for your lender. It is not, however, additional security for you.

Lenders are normally prepared only to lend about 75% of the value of a property or its purchase price (whichever is the lower). If you need to borrow more than this, your mortgage will be a **high loan-to-value** advance and you will normally be charged a fee for it (a variety of names exist for this fee, for example, **high**

percentage loan fee, high lending fee, additional security fee, etc). Payment of this fee therefore enables you to borrow more than your lender would normally be willing to lend on the security of the property alone.

Some lenders may use this fee to reimburse themselves for the amount they have paid for their mortgage indemnity insurance. Other lenders choose not to purchase indemnity insurance from an insurance company, preferring to use the fee to make other arrangements to cover the risk. The fee is **not**, therefore, the cost of mortgage indemnity insurance. It is just the cost to you of taking out a high loan-to-value mortgage.

What Happens When a Lender Makes a Mortgage Indemnity Claim?

A lender can make a claim after it **exercises its power of sale** (i.e., when the lender has actually sold the repossessed property) and the price obtained for your property is less than your outstanding mortgage. The difference between the amount the property is sold for and the amount of your outstanding mortgage is called a **shortfall**. When you take out a mortgage you make a personal promise to repay **all** of the money you owe under the mortgage. This promise still applies whether your lender has mortgage indemnity arrangements with an insurer or not. The fact that the lender has made a mortgage indemnity claim does not mean that you do not have to repay the shortfall.

In most cases, the mortgage indemnity will cover your lender only for part of its loss and, in addition, once an insurer has paid a mortgage indemnity claim, it gains the right of subrogation.

What Is Subrogation?

Subrogation means that the insurer can reclaim from you any money it has paid to your lender under a mortgage indemnity claim. Insurers always have the right to recover money they pay out under a claim where the loss has been caused by a "third party." In the case of mortgage indemnity, you, as the borrower, are the "third party" whose default led to your lender making the claim.

Either your lender or its insurer can take legal action against you to recover the shortfall if you do not repay it voluntarily, although any action would be taken in the name of the lender. In most cases, therefore, it is your lender who will contact you to recover the shortfall on behalf of itself and its insurer. This does not mean that the lender is claiming the debt twice; any money paid by the insurer which is collected from you will be passed back to the insurer. In some cases, however, the insurer may contact you directly.

The fact that your lender has mortgage indemnity insurance **does not** mean that you are less likely to be pursued for the shortfall than if no mortgage indemnity arrangements are in place. In both cases, your promise to

repay all of the money you owe applies, and lenders (and insurers) have 12 years (six in Scotland) in which to seek recovery from you of all the money that you owe.

Some People Say that Mortgage Indemnity Covers Me and Enables Me to Escape from Negative Equity.

How Can I Be Sure that this Advice Is Wrong?

Some advisers have misunderstood the nature of mortgage indemnity and the wordings of the mortgage indemnity policies, taking them to mean that mortgage indemnity covers borrowers. However, it is very clear, and has been confirmed by various cases in the courts,

that this is **not** the case and that mortgage indemnity covers **only** your lender and does **not** affect your personal promise and responsibility to repay the loan.

Consequently, you should be very wary of taking advice offered by any person or company that by simply handing your property back to your lender (known as “voluntary surrender”) you will be covered by your lender’s mortgage indemnity and so avoid the repayment of any shortfall. As you can see, such advice is wrong. You would remain responsible for repaying any shortfall and your chances of obtaining another mortgage, or any other form of credit in the future may be severely reduced. (For example, your name may be placed on the Council

of Mortgage Lenders’ Possessions Register, which most lenders check before granting a mortgage.)

This information sheet is intended as a general guide, and you should contact your lender for a fuller explanation, if necessary. If you have mortgage arrears, or if you are not in arrears but have negative equity and wish to move, talk to your lender about possible ways that it may be able to help you.

Lenders always try to be sympathetic to borrowers in genuine difficulty, **but** you cannot simply “hand in your keys” and walk away from your home and your mortgage. **Advice which says that you can is wrong.**