SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

BILL: CS/SB 834

SPONSOR: Banking and Insurance Committee and Senator Horne

SUBJECT: Mortgage Guaranty Insurance

DATE: April 10, 2000 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Emrich	Deffenbaugh	BI	Favorable/CS
2.				
3.				
4.				
5.				

I. Summary:

Mortgage guaranty insurance protects a lender, usually a bank or mortgage company, against loss of all or a portion of the principal amount of a mortgage loan upon the default of the homeowner.

Florida law specifies certain minimum surplus and capital requirements for a mortgage guaranty insurance company to transact insurance in the state. The requisite minimum surplus must be equivalent to the greater of 10 percent of a company’s liabilities, or $4 million, but not more than $100 million. For the purpose of determining the minimum surplus, specified liabilities are charged against certain assets and a company’s contingency reserves are considered a liability. A contingency reserve must be established by each mortgage guaranty insurance company as a solvency requirement to protect policyholders against the effect of adverse economic conditions. Each insurer must contribute an amount equal to 50 percent of earned premiums on each policy it writes into a contingency reserve and maintain such reserve over 10 years. The contingency reserve must also be reported as a liability in the insurer’s financial statements filed with the Department of Insurance. Therefore, a company’s contingency reserve is counted by the department as a liability in determining whether the insurers minimum surplus equals 10 percent of its liabilities.

Under the Committee Substitute for Senate Bill 834, each mortgage guaranty insurer would continue to report its contingency reserve as a liability in financial statements filed with the department. However, the contingency reserve would *not be considered as a liability* for the purpose of determining whether the mortgage guaranty insurer met the requisite minimum surplus requirements which are the greater of 10 percent of the insurers liabilities, or $4 million. The effect of this bill would be to reduce a company’s liability by the amount of their contingency reserve solely for the purpose of calculating the company’s minimum surplus.

The Committee Substitute also clarifies current law by requiring mortgage guaranty insurers to have sufficient capital and surplus so that their total outstanding aggregate exposure (net of reinsurance) of their written policies does not exceed 25 times its paid-in capital, surplus, and

contingency reserve combined. It requires the insurer to disclose its total aggregate exposure (net of reinsurance) in their audited financial report which is submitted to the department and authorizes the department to take administrative action against a mortgage guaranty insurer if the insurer is not in compliance with these requirements.

The current law prohibits a mortgage guaranty insurer from having outstanding a total liability net of reinsurance, under its aggregate mortgage guaranty insurance policies, exceeding 25 times its paid-in capital, surplus, and contingency reserve combined.

This Committee Substitute amends the following sections of the Florida Statutes: 624.408 and 635.042.

II. Present Situation:

Mortgage Guaranty Insurance

Under Florida law, mortgage guaranty insurance protects a lender, usually a bank or mortgage company, against loss of all or a portion of the principal amount of a mortgage loan upon the default of the homeowner.[1] This type of insurance provides no protection other than against loss due to default. It differs from homeowners insurance which is coverage the lending institution will require, if a home is mortgaged, on the structure of the house. Homeowners' insurance helps pay to repair or rebuild a home and replace personal possessions lost to theft, fire or other disasters, such as storms.

Mortgage guaranty insurance is provided primarily to guaranty first mortgage loans and coverage can range from as little as 5 percent to as much as 100 percent of the outstanding loan amount on individual policies. According to the National Association of Insurance Commissioners (NAIC), most policies cover 10 percent to 30 percent of the loan amount and are written on first mortgage loans that represent a high percentage, generally 80 to 95 percent, of the value of the mortgaged property (NAIC publication: *Mortgage Guaranty Insurance Accounting Principles Supplement)*.

Such insurance is marketed through licensed agents directly to mortgage lenders, e.g., banks, mortgage companies, credit unions, and state and local housing authorities. Lenders obtain mortgage guaranty insurance in order to facilitate sales of mortgage loans in secondary markets.

Premium rates for mortgage guaranty insurance are generally based upon: 1) the percentage of insurance coverage provided; 2) the ratio of the insured mortgage loan to the property value or sales price; and, 3) the term and premium payment method selected by the lender. If a default by the homeowner occurs, the insurer generally requires the lender to foreclose on the home and tender merchantable title to the mortgaged property in order to make a claim.

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[1]Such insurance is regulated by the Department of Insurance under ch. 635, F.S. Section 635.011, F.S., specifies that mortgage guaranty insurance is a form of casualty insurance insuring lenders against:

(a) financial loss by reason of nonpayment of principal, interest, and other sums agreed to be paid under the terms of any note or indebtedness secured by a mortgage on real estate.

(b) financial loss by reason of nonpayment of rent agreed to be paid under terms of a lease for possession of real estate.

The nature of the insured risk for mortgage guaranty insurance is influenced by certain factors which set such insurance in some respects apart from other types of insurance. For example, the exposure period for a particular risk is significantly longer for mortgage guaranty insurance because it can run for the term of the mortgage.[2] Further, such insurance is renewable at the option of the insured and at the rate quoted when the policy was issued. The fact that mortgage guaranty insurance is guaranteed renewable at a definite rate is one of the factors necessitating the establishment of a contingency reserve. Such a reserve primarily protects against catastrophic economic events. Under Florida law, a "contingency reserve" is a special premium reserve which is in addition to other premium reserves required by law and is established for the protection of policyholders against the effect of adverse economic cycles (s. 635.011, F.S.). Catastrophic economic conditions strongly influence the frequency of loss because during a severe depression in the economy, widespread defaults by borrowers can occur. The magnitude of such loss has no analogy in other property lines of insurance other than catastrophe (hurricane, earthquake) losses for property insurers.

Special Regulatory Requirements for Mortgage Guaranty Insurers

Florida law specifies certain minimum surplus and capital requirements for a mortgage guaranty insurance company to transact insurance in the state. The requisite minimum surplus must be equivalent to the greater of 10 percent of a company's liabilities, or $4 million, but not more than $100 million (s. 624.408, F.S.). For the purpose of determining the minimum surplus, specified liabilities are charged against certain assets and a company's contingency reserves are considered a liability. A contingency reserve must be established by each mortgage guaranty insurance company as a solvency requirement to protect policyholders against the effect of adverse economic conditions (s. 635.011, F.S.). Each insurer must contribute an amount equal to 50 percent of earned premiums on each policy it writes into a contingency reserve and maintain such reserve over 10 years (s. 635.041, F.S.). In other words, insurers must set aside 50 cents of each premium dollar earned and maintain the contingency reserve for a period of 10 years, regardless of the length of coverage of the particular policy for which the premium was paid. The reserve may be reduced within this 10-year period only when losses in a calendar year exceed 35 percent of earned premiums.

The contingency reserve must also be reported as a liability in the insurer's financial statements filed with the Department of Insurance. Therefore, a company's contingency reserve is counted by the department as a liability in determining whether the insurer's minimum surplus equals 10 percent of its liabilities.

The current law prohibits a mortgage guaranty insurer from having outstanding a total liability net of reinsurance, under its aggregate mortgage guaranty insurance policies, exceeding 25 times its paid-in capital, surplus, and contingency reserve combined (s. 635.042, F.S.).

A current situation which has led to the filing of this bill concerns a large mortgage guaranty insurer which, in its 1998 Annual Statement, failed to meet the minimum surplus requirements according to the Department of Insurance. Department officials stated that the company listed

[2] According to the NAIC, the average policy life is 7 years.

approximately $1 billion in liabilities while reporting $95 million in surplus, thus falling below the minimum surplus (10 percent of liabilities) requirement by approximately $5 million. The company had argued that its surplus was well in excess of the required minimum surplus requirements if its contingency reserve, which totaled over $740 million, could be considered as surplus or not counted as a liability for purposes of the 10 percent calculation. Its total liabilities, excluding the contingency reserve, were $291.9 million and 10 percent of this total amounted to $29.2 million. The company's actual surplus as to policyholders was about $95 million and therefore greatly exceeded the required minimum under the insurers interpretation. However, the department stated in its denial letter that pursuant to s. 635.041, F.S., the company's contingency reserve must be maintained as a liability.

According to the NAIC, there are two predominant practices among the states which are being used to report the effect of contingency reserve transactions. Some jurisdictions, like Florida, report changes in the contingency reserve in the income statement. That is, the liability for the contingency reserve is included in loss reserves and the net addition to (or deduction from) the contingency reserve liability is reported as a deduction from (or addition to) underwriting income in the income statement. Other states report changes to the contingency reserve as a direct adjustment to surplus, meaning the liability for contingency reserves is reported as a separate line item among other liabilities. The net addition to (or deduction from) the contingency reserve liability is not recorded in the income statement, but rather it is reported as a direct adjustment to surplus.

Florida's minimum surplus requirement of the equivalent to the greater of 10 percent of a company's liabilities, or $4 million, appears to be unique or at least uncommon as compared to other states which require insurers to maintain a flat dollar amount as a minimum surplus. When the 10 percent calculation is applied to the contingency reserve, Florida's requirement results in insurers having to maintain an overall higher surplus than other states.

III. Effect of Proposed Changes:

Section 1. Amends s. 624.408, F.S., relating to required surplus as to policyholders, to exempt mortgage guaranty insurance from the minimum surplus requirements of this section and to provide that mortgage guaranty insurers shall have and maintain a minimum surplus as required by s. 635.042, F.S. (Section 2 of the bill).

Section 2. Amends s. 635.042, F.S., to revise the minimum surplus requirements for mortgage guaranty insurers. The bill requires that mortgage guaranty insurers maintain a minimum surplus equal to the greater of $4 million, or 10 percent of liabilities, not to exceed $100 million which is the current law in s. 624.408, F.S. Unlike current law, however, the bill provides that an insurer's "contingency reserve" is not considered as a liability for the purposes of calculating 10 percent of liabilities.

The bill clarifies current law by requiring mortgage guaranty insurers to have sufficient capital and surplus so that their total outstanding aggregate exposure (net of reinsurance) of their written policies does not exceed 25 times its paid capital, surplus, and contingency reserve combined. It further requires mortgage guaranty insurer's to disclose their total aggregate exposure (net of reinsurance) in their audited financial report which is submitted to the Department of Insurance.

Finally, it authorizes the department to take administrative action against a mortgage guaranty insurer if the insurer is not in compliance with these requirements. Administrative action may include a fine, suspension or revocation of the insurers license.

Section 3. Provides that the act shall take effect July 1, 2000.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

As discussed above, mortgage guaranty insurers will benefit because they can decrease their liabilities by the amount of their contingency reserve for the sole purpose of calculating their minimum surplus requirements. However, the bill is consistent with the solvency standards utilized by most states, which rely on the contingency reserve and the 25 to 1 limit on outstanding risk to capital, surplus, and contingency reserve combined.

However, according to representatives with the Department of Insurance, lowering the surplus requirements for mortgage guaranty insurers could potentially result in "private sector costs to policyholders from insolvencies." The Florida Insurance Guaranty Association (which pays policyholder claims when companies become insolvent) does not cover mortgage guaranty insurance.

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.