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Resources, Community, and
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The Honorable Phil Gramm
Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable James A. Leach
Chairman
The Honorable John J. LaFalce
Ranking Minority Member
Committee on Banking and
Financial Services
House of Representatives

Subject: Homeownership: Cancellation and Termination Provisions of the Homeowners Protection Act of 1998

The Homeowners Protection Act of 1998[1] contains provisions for terminating the private mortgage insurance that homeowners are required to obtain when they have made a small down payment on a home mortgage loan. Private mortgage insurance protects the lender if the homeowner defaults on the loan. Specifically, for certain residential mortgage loans closed on or after July 29, 1999, the act provides that the borrower may cancel this insurance when the principal balance of the mortgage reaches 80 percent of the original value of the property securing the loan. If the borrower does not cancel the insurance, the lender must do so when the mortgage balance reaches 78 percent of the original value of the property securing the loan. However, these cancellation and termination provisions do not apply if the loan has what the act calls "high risks" associated with it—a term that the act does not explicitly define. The act directs the Comptroller General of the United States to report to the Congress, no later than 2 years after the date of the act's enactment, on the number and characteristics of the residential mortgage loans that are considered high risk and are therefore excluded from the routine cancellation and termination provisions. This letter describes our efforts to respond to this requirement.

The Homeowners Protection Act of 1998

Mortgage insurance is generally required when a borrower makes a low down payment on a mortgage loan. Studies show that a borrower with less than 20 percent invested in a house is more likely to default on a mortgage than a borrower who has made a larger down payment.

[1] P.L. 105-216, July 29, 1998.

Under the act, if the borrower has a good payment history, he or she may cancel his or her private mortgage insurance when the principal balance of the mortgage reaches 80 percent of the original value of the property securing the loan. If the borrower does not cancel the insurance, the lender must do so when the mortgage balance reaches 78 percent of the original value of the property securing the loan provided the borrower is current on the mortgage payments. Moreover, private mortgage insurance cannot be required beyond the midpoint of the mortgage if the borrower is current on the mortgage payments.

The act qualifies this requirement by stating that the provisions for canceling and terminating private mortgage insurance do not apply if the mortgage has "high risks" associated with it. The act does not define this term but stipulates that conforming loans (limited to $240,000),[2] may be designated as high risk in accordance with guidelines established by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).[3] For mortgage loans of more than $240,000 (nonconforming loans), the lender can define what constitutes high risk. Finally, for loans defined by lenders as high risk, the act requires that private mortgage insurance be terminated when the principal balance of the mortgage reaches 77 percent of the original value of the property securing the loan. The act does not indicate whether private mortgage insurance can be required beyond this point if the borrower has a poor payment history.

Implementation of the Act's Requirements May Be Limited

Fannie Mae and Freddie Mac have not defined "high risk." Instead, they have decided to treat all conforming mortgages the same way and not apply the act's high-risk provisions for canceling or terminating private mortgage insurance to specific mortgages. For conforming mortgages, therefore, the act's exception for high-risk loans has had no effect. With respect to nonconforming loans, two trade associations–the Mortgage Bankers Association of America and America's Community Bankers–have published a guide on implementing the act's cancellation and termination provisions. These organizations have chosen, as Fannie Mae and Freddie Mac have done, not to define high-risk mortgages in this guide.

We believe that a mortgage lender would gain little by invoking the high-risk provisions for a mortgage of more than $240,000 because these provisions do not explicitly stipulate that the borrower have a good payment history or be current on the loan. According to the Mortgage Bankers Association and America's Community Bankers, the benefit a lender might derive by terminating the private mortgage insurance on a lender-designated high-risk loan at 77 percent–compared with 78 percent for a non-high-risk loan–may be outweighed by the apparent lack of a requirement in the act for the borrower to be current on his or her mortgage payments. As a result, we believe there is a disincentive for lenders to invoke the high-risk exception.

We believe that attempting to determine the number and characteristics of high-risk mortgages would not, in all likelihood, produce information helpful to congressional decisionmakers for two reasons. First, Fannie Mae and Freddie Mac have decided to treat all mortgages the same way and not apply the act's high-risk provisions for canceling or terminating private mortgage insurance to specific mortgages. Second, the number of lenders who would define some mortgage loans of more than $240,000 as high risk would, in our view, likely be small because of the disincentive in the act for lenders to define such

[2] Currently, Fannie Mae and Freddie Mac buy mortgages up to a loan limit of $240,000. On January 1, 2000, the conforming loan limit will increase to $252,700.

[3] Fannie Mae and Freddie Mac were chartered by the Congress to increase the supply of money that mortgage lenders can make available to home buyers and multifamily investors.

loans as high risk. If it becomes apparent that Fannie Mae and Freddie Mac are planning to change their position or that private lenders have decided to invoke the high-risk exception, we would certainly revisit the issue. We hope this information is responsive to your needs.

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If you have any questions, please contact me at (202) 512-7631. Key contributors to this report were Robert Procaccini and Frank J. Minore.

Judy A. England-Joseph
Director, Housing and Community
Development Issues

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