



The Underwriting of Mortgage Broker and Lender Bonds – The Basics

A surety bond is a three party agreement by which the obligation owed by one party (the principal) to another party (the obligee) is secured by a third party (the surety). Such a guarantee is essential when a governmental agency confers a benefit upon an individual, such as a license to operate as a mortgage lender or broker. As part of its oversight activities, the governmental entity needs the certainty that the entity is qualified to perform or conduct its activities properly. Bonds are valuable products used in a variety of ways to provide consumer protection and protect the public treasury.

Surety bonds provide two valuable services. The better-known service of the surety is to perform its stated bond obligation and provide financial protection in the event the bond principal defaults in its performance. In such an event, the surety steps in to handle the claims on the bond and perform pursuant to the conditions of the bond and the applicable statutory or regulatory language.

While claims handling is a critical function of the surety, another equally critical but much less heralded function is the surety's prequalification of a principal before the surety will write a bond. A surety seeks to avoid a default of the obligation through the process of prequalification. Through this process, brokers or lenders that the surety has determined to be capable and qualified can obtain a bond and consequently a license. This service of the surety is a valuable and necessary service and important in helping to eliminate fraudulent or unqualified entities from a business. This function of the surety is an invaluable one for states in their efforts to regulate businesses.

In underwriting the bond, the surety will examine the licensee's financial strength by examining financial statements and credit reports of the mortgage broker firm as well as possibly the statements of the firm's owners. The surety must determine if the firm is financially strong enough to sustain the business. (Has the firm demonstrated a consistent record of operational profitability? Does the firm have sufficient working capital and net worth to handle any contingencies?) In addition, a surety can seek reimbursement from the firm for any loss incurred by the surety. Thus the surety will determine if the firm has sufficient assets and liquidity relative to the full penal sum of the bond.

In addition to a financial assessment, sureties examine the qualitative characteristics of the mortgage broker. Sureties will review the experience and capabilities of the key persons of the organization. Sureties will examine the following other business practices of the firm:

- Does the broker/lender focus primarily on the residential or commercial market?
- Does the broker also act as a lender, creating additional risks and exposures?
- Does the broker/lender handle clients' money? Are there escrow funds? What are the money handling procedures?
- Does the broker/lender have fidelity coverage? What are the limits?
- Does the broker/lender have E&O coverage? What are the limits?
- In how many and which states is the broker/lender licensed in?
- Does the broker hire "contractors" and if it does, how are the contractors managed?"
- What kind of loans does the broker/lender handle (e.g. subprime, Alt A, etc)?
- Who are the broker's lenders?

Sureties also will examine the risk presented by the applicable regulation and bond form. Does the form contain certain onerous provisions that increase the surety's risk? The form should clearly present the nature and purpose of the bond requirement. The underlying obligation to be secured by the bond should be stated clearly – usually compliance with the applicable statute and regulations.

The bond amount should provide a strong incentive for compliance and it should have some correlation to the risk being underwritten. The amount should also be reasonable. As the bond amount increases, the surety increases the financial threshold as to the size of the bond principal that can qualify for the bond. If the statute requires an unduly high bond size, or results in unduly high aggregate liability, many individual mortgage brokers may not be able to obtain bonds. Only large and well capitalized businesses would be bondable. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) also now requires that state license bond amounts reflect the dollar amount of the loans originated.

The form should state the eligible claimants. License bonds usually run to the State for the benefit of any person injured by the wrongful acts of the principal (mortgage broker). Generally, only the State can make a claim under the license bond, and the State can take the proceeds and use them as appropriate to remedy the consumer harm. If consumer claimants can take action directly, the claimants who first sue and/or settle could collect the amount of their judgment in full, reducing the amount of the penal sum available to later claimants and to the State. The State is in a better position to address competing claims to ensure a fair distribution of the bond penalty.

For the protection of the public as well as the surety, the surety should be able to cancel the bonds required on reasonable advance notice to the state regulator. In this way, if the surety believes that the provider is violating the terms of its licensure or developments now adversely affect the principal's capabilities, the surety can act. Cancellation possibly is an indication the surety has concerns about the principal's operations. This protects the surety by allowing it to stop further liability, but also protects the public by terminating the license if the surety detects concerns. (Of course, cancellation also could mean simply that the current surety is being replaced by another surety. Nevertheless, cancellation can be a "warning system" for the State to trigger further inquiry.)

In addition, the bond form should explicitly state that the surety's aggregate liability is the penal sum of the bond. Such a provision avoids the misinterpretation that a separate bond limit applies to each claim or that the bond amount increases for each year the bond is in effect. A bond with such cumulative liability is not widely available as the surety cannot assess its maximum exposure under the bond.

License bonds usually run concurrent with the license period and any renewal of such periods. If the license or registration is revoked or suspended for any reason, the license bond generally will become ineffective as the license period will have ended.

The cost of a bond will vary by surety company depending on each company's underwriting and rating factors. As a general rule, the cost of a mortgage broker bond will range from 1% to 2% of the bond amount on an annual basis. All insurance companies must charge the rates that they have on file and that have been approved by the state insurance department.

A bond form illustrating the characteristics discussed above is attached. Also attached are suggested regulatory provisions to implement the bonding requirements under the SAFE Act, and in particular, the requirement that the bond reflect the amount of the loans originated.