The Future of Mortgage Loan Surveys (Inspections)

by

Knud E. Hermansen[1]

Ph.D., P.L.S., P.E., Esq.

I have frequently been asked about the future of mortgage loan surveys.[2] I will attempt to give the general consensus among title attorneys and real estate attorneys on the future of mortgage loan surveys. To comprehend the future of mortgage loan surveys, real estate practitioners must have a general understanding of mortgage title insurance and risk factors.

The mortgage loan survey can trace its inception to the regulations governing the secondary mortgage market. These regulations promulgated in part by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) require all mortgages sold on the secondary mortgage market have title insurance covering the mortgaged property. Furthermore, the title insurance cannot contain a survey exception. To remove the survey exception, title insurance agents have required “accurate surveys” as evidenced by survey plans depicting the property. A plan allowed the agents to remove the survey exception from the title policy. It should be made clear at this point that the title policy is for the mortgagee and NOT the buyer. While the buyer can and frequently does purchase title insurance, the buyer’s policy usually does contain the survey exception and may have different terms. As a result, the property may have two insurance policies written for it. One policy will be written to protect the mortgagee and another separate and different policy is written to protect the buyer.

The terms of the mortgagee’s title insurance policy will usually provide payment in the form of coverage in the event three conditions occur. First, the title (or more properly the mortgage) to the property is jeopardized or made unmarketable. Second, the buyer or purchaser of the property (mortgagor) stops paying on the loan. Third and finally, after the lending institution calls in the note and sells the

1 Knud Hermansen has a Ph.D. in civil engineering from the Pennsylvania State University and a J.D. from West Virginia University. Currently, he practices law, surveying, and engineering in Old Town, Maine and is an associate professor in civil engineering technology and surveying engineering at the University of Maine.

2 Also known as mortgage loan inspections, inspections, location surveys, etc.

Surveyor, Civil Engineer, & Counselor at Law
R.D.2, 1955 Poplar Street
Old Town, Maine 04468
Phone: 207-827-6187

property, the net amount received must be less than the outstanding balance of the mortgage. Until the last two conditions occur, the mortgagee has not suffered any damages.

Insurers make money by knowing the risks. The less the risk, the less the insurer is concerned. What surprises many surveyors is that survey problems present little or no risk for mortgage title insurance. To understand the last statement, consider an example of the mortgage market of the future where no surveys may be required to obtain mortgagee title insurance.

Albeit, most property does not have a title problem, but for purposes of carrying an example forward assume 20% of the mortgaged properties have a title problem. Of the 20%, assume one-half of the problems could have only been discovered by an accurate survey. As a result, 10% of the mortgaged properties have title problems only discoverable by an accurate survey. Furthermore, assume 10% of these problems are substantial. This would include such problems as the garage or entire septic field extending over the boundary onto the neighbor’s property. At this point, we have 1 out of every 100 properties or 1% of the mortgaged property with substantial title defects that could have been discovered by an accurate survey.

This number does not represent the title insurer’s risk on the mortgage title insurance. As previously stated, the mortgagee’s title insurance does not have to pay damages yet. First, the buyer must stop paying on the mortgage. Realistically, this does not happen even if the garage or septic field is discovered to reside on the wrong side of the boundary. If the buyer were to stop paying on the mortgage, the buyer creates several problems for themselves. First, the buyer runs the danger of losing the equity they have accumulated in the home. Since most mortgages start at 80% or less of the appraised value, even the most recent home purchaser risks losing up to 20% of the appraised value by walking away. Second, the buyer that walks away from the mortgage still has to rent or pay for housing someplace else. Faced with this prospect, most buyers think it is better to pay for a house they own and a garage they don’t own than pay rent for a house and garage they don’t and will never own. Third, the cost for removing the garage or coming to terms with the neighbor may be expensive but it will usually be less expensive than walking away from the mortgage. Walking away from the mortgage risks an expensive lawsuit and probable loss of a good credit rating. Failure to pay on a mortgage, no matter how justified, will almost certainly cause a request for a loan to purchase another home to be denied. Finally, walking away from the mortgage is not the same as walking away from the debt. A person has an obligation to pay even if the lending institution has collateral to seize. The lending institution may opt to sue on the note only or foreclose and sue for any remainder under the note. The bottom line is that the buyer will owe the money no matter how big the problem with the title.

Going back to the example again, it appears reasonable to state that only 0.5% of the serious title defects will result in the buyer refusing to pay on the mortgage. Even in the few cases this percentage represents, the mortgagee's title company still does not have to pay compensation. The final condition for compensation has not been met. The bank must foreclose on the note, sell the property, and fail to recover the outstanding amount. Therefore, to continue with the example, assume less than 10% of foreclosures bring less than the outstanding mortgage. This is a reasonable assumption since mortgages seldom exceed 80% of the appraised value, five or more years of payments have been made before foreclosure occurs, and many banks simply refuse to sell the property by foreclosure for less than the outstanding mortgage. The end result of all these events coming together in this example is that an insurance firm risks paying substantial damages (buying the mortgage) one time for every 200,000 mortgages. (To put this in perspective, if the insurance were to stop asking for mortgage surveys and charge $1 more for each policy, they could save the buyer an extra $100-$300 in closing costs and have the money to purchase the typical residential mortgage if forced to buy one.)

Given these small risks, what does this mean for the surveyor who prepares mortgage surveys. First, as most surveyors are well aware, the title insurance company is not concerned with the quality of the product. They don't pay for the services and they will not suffer for poor quality services except in extremely rare cases. Second, to lower closing costs and remain competitive with other lending institutions, they can safely look toward reducing or eliminating the survey costs. In many cases banks are already allowing the less costly owner affidavits to substitute for surveys. In other words, the mortgagee's title insurer and the lending institution have little if any risk even if every transaction uses an owner's affidavit. Under the circumstances, a mortgage loan survey cannot be cheap enough because the surveyor is competing against a free or nominal costing piece of paper with no realistic increase in risk imposed on the title insurer. The trend to pay less concern with the survey exception can be expected to continue until the survey exception is removed as a matter of course from the mortgagee's title policy.

For surveyors that have looked down upon mortgage loan surveys as being sub-professional services this is good news — the temptation for surveyors to perform these services will be gone. Surveyors that have counted on these services to sustain their business are probably horrified at the thought that this service will no longer be sought by lending institutions. In order to prevent loss of business, these surveyors have sought to prevent owner's affidavits or require surveys with every sale. Realistically, both efforts are probably doomed to failure. First, outlawing owner's affidavits will not force insurers to start requiring surveys again. On the contrary, insurers will jump directly to the inevitable and not require surveys or affidavits. Second, state statutes requiring surveys will have no affect on the title insurance industry. The secondary mortgage market and to a large extent lending institution regulations are governed by federal regulations — not state regulations. It is probably an accurate statement to say that the lending institutions and title insurers will generally ignore state regulations with impunity. On the other hand, the buyer will be affected by any statute requiring surveys at closing. As a result, buyers can be expected to either show outrage at the additional cost of closing or continue to seek the low costs "inspections" and use them like they were high cost, quality surveys. In each situation the surveyor will be the loser.

In conclusion, the real estate practitioner who has relied upon mortgage loan surveys in their real estate business should continue to advise clients to obtain surveying services prior to closing. Surveying services performed by competent surveyors do disclose potential problems. As a result, real estate practitioners should continue to view surveying services as indispensable for closing — similar to radon tests, termite inspections, building inspections, and other common services usually sought by the cautious buyer. The value of a survey of the property before purchase should be stressed to the client.

Knud E. Hermansen
Surveyor, Civil Engineer, & Counselor at Law
R.D.2, 1955 Poplar Street
Old Town, Maine 04468
Phone: 207-827-6187