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MORTGAGE INSURANCE: COMPARING PRIVATE SECTOR AND GOVERNMENT-SUBSIDIZED APPROACHES

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND INSURANCE

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Hearing held on:	
March 13, 2013	1
Appendix:	
March 13, 2013	43

WITNESSES

WEDNESDAY, MARCH 13, 2013

Bazemore, Teresa Bryce, President, Radian Guaranty, Inc.	15
Bjurstrom, Kenneth A., Principal and Financial Consultant, Milliman	7
Chappelle, Brian, Partner, Potomac Partners LLC	11
Shapo, Nat, Partner, Katten Muchin Rosenman LLP	9
Stelmach, Stephen, Senior Vice President and Research Analyst, FBR Capital Markets & Co.	13

APPENDIX

Prepared statements:	
Neugebauer, Hon. Randy	44
Bazemore, Teresa Bryce	46
Bjurstrom, Kenneth A.	65
Chappelle, Brian	76
Shapo, Nat	88
Stelmach, Stephen	99

MORTGAGE INSURANCE: COMPARING PRIVATE SECTOR AND GOVERNMENT-SUBSIDIZED APPROACHES

Wednesday, March 13, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Luetkemeyer, Royce, Miller, Capito, Garrett, Westmoreland, Hurt, Stivers; Capuano, Velazquez, Cleaver, Sherman, Himes, Sinema, and Beatty.

Ex officio present: Representative Hensarling.

Also present: Representative Green.

Chairman NEUGEBAUER. Good morning. This hearing of the Housing and Insurance Subcommittee will come to order. By mutual agreement, we will have opening statements, about 10 minutes on each side, as previously agreed. And there may be members of the full Financial Services Committee who want to participate in this hearing today, so I ask unanimous consent that members of the Financial Services Committee who are not members of the subcommittee and who have joined us today will be entitled to participate. Without objection, it is so ordered.

This is our third hearing that we have done on FHA. And the reason we have had so many hearings is that FHA is an important component of the housing and the finance markets in this country. And they have become a larger and larger portion of the business, in controlling over 50 percent, for example, of the mortgage insurance premium in this country.

This is no small insurance company. This insurance company has over a trillion dollars worth of business on the books. What does that mean? It means that because it is a government-backed entity, the taxpayers are, in fact, on the hook for over a trillion dollars worth of mortgages in this country.

But the other aspect of it is that it is disturbing to find that this entity—as we have learned in previous hearings—is somewhat in financial straits. It is an entity that basically, has a negative net worth. And so, you have an over-trillion-dollar entity that is backed by the American taxpayers that has a negative net worth.

Now, any other company like that would be in bankruptcy or receivership. And so, I think that this may be the most important hearing we have had so far. Because today what we are going to analyze is if FHA is, in fact, an insurance company, which they are, then are they operating like traditional insurance companies? And we are going to hear from witnesses today who will tell us a little bit about what the profile of a entity like this should look like if it were in the private sector. Why is it important that we compare them to the private sector? It is important that we compare them to the private sector because they are competing with the private sector. That is one reason. But the other reason for them to be run in a financially sound way is the fact that the taxpayers are on the hook for these mortgages. And so, we need to make sure that the people who are enjoying the benefits of having an FHA loan in this country are actually carrying their load, and that they are not actually putting the taxpayers at risk.

Because for those people who don't have an FHA mortgage or have a private mortgage, they are, in fact, being penalized because they are paying their mortgage and they are paying the risk premium for having a privately-insured mortgage. But at the same time, they are at risk of also subsidizing the premium for people who have an FHA loan. So there are a number of areas where we are going to explore today.

I want to make sure that we have an open and honest discussion. And one of the things that we want to make sure of is that as we move forward, we make sure that FHA is operating within what I think is the congressional intent. It has gotten to be a much bigger organization, and it is actually growing at an exponential rate. It is growing faster than it is ever grown and it is bigger than it has ever been. And the question is, is this the FHA that Congress intended, and is this FHA being run in an appropriate way for the American taxpayers?

So, I look forward to the hearing, and I look forward to hearing from the witnesses today. And with that, I will yield back my time and recognize the ranking member of the subcommittee, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman, for holding this hearing, and I certainly welcome our witnesses. I look forward to your testimony.

The bottom line is, I agree with many of the things that the chairman said. The FHA, we all know, has grown. We have differences of opinion as to why it has grown and what would have happened had it not grown. I happen to believe that had it not grown at the time it did, there would be no housing market right now. Now, granted, that is past tense in 2008 and 2009 and 2010. The question is, what do we do from this point forward?

From what I see, things are moving in the right direction. The FHA is slowly but surely and steadily, thoughtfully decreasing its share of the market, and private enterprise is coming back into the market the way it should. Nonetheless, I think it is fair and reasonable to ask all these questions. And also to oversee to make sure the FHA is doing what Congress wants it to do. I think all that is fine, I think it is good, and I think it is useful.

And those are the aspects on which I agree with the chairman. I do have some concern, however, that a lot of these hearings are being used simply as a setup to make sure that when the time comes, private enterprise will be able to grab a larger share than they have ever had in any traditional sense of the word. We will be a little bit careful of that, only because I like the housing market that we had for 40 years.

Granted, it got out of whack and we need to put it back in whack. But I don't want to go overboard and completely disincentivize the entire middle class from ever being able to purchase a home. I think that is part of the balance here. I am also a little concerned that some of the things that are happening might be used, at some point, to make a political point. For instance, as I understand the law, the FHA is required by law to access certain Treasury funds even though they don't need them.

So I will be asking each witness if you think the FHA will actually need to borrow Federal dollars this fiscal year regardless of what the law says. Not access the money, because as I understand the law they have to, but do you think the FHA this year will have to access anything outside of their own funds? And if the answer is yes, you will have to explain to me why. And that is why I filed H.R. 1028, which simply repeals the section of the law that requires the FHA to access Treasury funds when they don't need them.

It is a ridiculous law that I never knew existed until we hit this particular situation. I guess it is excessive. It is belt-and-suspenders, and maybe two-belts-and-two-suspenders. It is a little bit of overkill to make sure that the FHA stays whole. And I think it is unnecessary and inappropriate. But nonetheless, we will see if some of my colleagues will help pass that bill to get the FHA on the footing that it deserves and to not jeopardize taxpayer dollars unless it is absolutely necessary.

So I look forward to your testimony today, and I look forward to making sure, together with the chairman and other members, that the FHA is doing what we wanted it to do when it was originally created.

Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the vice chairman of the subcommittee, Mr. Luetkemeyer from Missouri.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. And thank you for the important salient hearing we are having today.

Regardless of political ideology, there are certain facts about FHA that can't be denied: one, FHA's market share has grown considerably over time; two, FHA insures more than $1 trillion worth of mortgages on more than 7 million loans; three, FHA has the authority to draw funds directly from the U.S. Treasury; and four, FHA's Mutual Mortgage Insurance Fund, or MMIF, has a capital ratio that has fallen below the statutorily-required level of 2 percent.

In fact, during Fiscal Year 2012, the capital reserve ratio fell to a negative 1.44 percent. Despite these facts, FHA's book of business continues to grow as the private market is being forced to comply with stricter regulations and standards. As someone who has spent

many years in the banking and insurance industry, I respect and understand the importance of the sound tenets in lending and underwriting. And looking at the data surrounding FHA's finances, it is clear that they are not employing sound practices.

What is most disturbing about this is that the taxpayers are the ultimate backstop for FHA's sloppy work. The simple truth of the matter is that FHA needs to be examined and needs to be held to the same standards, high standards, that they are currently operating under. I look forward to hearing from our witnesses today, particularly about how we can return FHA to its original mission, ensure that they follow the sound tenets in lending and underwriting, and help spur growth in the private mortgage insurance market.

Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentleman, and I also want to recognize that the chairman of the full Financial Services Committee, Mr. Hensarling, has joined us today. It is good to have you in the hearing.

Now, I recognize the gentleman from Missouri, Mr. Cleaver, for 2 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman, and I do appreciate very much the fact that you have called three hearings to deal with FHA. And I think a part of this committee's benefit to the entire body is, you have been in municipal government and our ranking member came out of municipal government. And FHA has played a role since the Depression in keeping the housing market in this country sound.

I am not sure I would agree that FHA is crowding out the private industry. Because when you think about it, before the housing crisis, there were 10 private mortgage insurance companies. Almost all of them went bankrupt, almost all of them. And it was at a time that we needed FHA to step in, and they did. And with recovery on its way, I think it is on the horizon.

Private mortgage insurance posted their best year since the collapse in 2008. I was looking at this report from Inside Mortgage Finance that they put out, I think, on a monthly basis. Private mortgage insurance reported $175 billion in total new insurance written in 2012, more than doubling the amount of the business they did the year before, according to Inside Mortgage. So I do think that there may be a need for us to discuss this and massage it.

But the truth of the matter is, FHA is still providing a service that we desperately need, and I look forward to interacting with our panel.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now Gary Miller, the vice chairman of the full Financial Services Committee, is recognized for 2 minutes.

Mr. MILLER. Thank you, Mr. Chairman. I don't think that we can argue that we must respond to the reality the FHA wasn't prepared to have the pressure it faced during the downturn crisis. But we also face the reality that the private sector and FHA are somewhat different. FHA was driven by a mission structure. The private

sector is driven by a profit structure, which is most appropriate. But let's look at fair competition.

I guess the question we need to ask is, was the FHA crowding out, or was there no crowding-in by the private sector? I think that is something we don't have an answer to right now. And I think we need to look at the structure that caused the lack of crowding-in. If you look at Basel QM—QRM, we are doing everything from a structural perspective from Congress to basically make sure the private sector does not come in when they should be.

And if you look at the FHA, they play a countercyclical role. They grew when the private sector didn't come in. But now it is time to look at how do we ratchet back the FHA and other groups to let the private sector come in. That is something we need to really look at. And the latest actuarial review makes it clear that FHA wasn't fully prepared for the strains they faced during the downturn. They had five increases in fees. Were they appropriately timed, could they have moved in quicker?

We need to explore the mechanics of the private sector mortgage market and ask, how do we evaluate their operational structure and apply that to FHA, determine where reforms are needed, to make sure FHA can play this countercyclical role they are intended to play? But we need to respond to certain things that FHA has done to make sure they can perform their function in the future. We need to ensure their management system and technology are appropriate to do the job they are supposed to do.

We need to make sure that they ensure that appropriate credit quality is preserved in the system. I have introduced legislation in the past to make sure they would do that and, for some reason, that is not occurred. And we need to demand that FHA remain adequately capitalized. There are a lot of questions and a lot of concerns I have, and I am sad to say my time has expired.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from California, Mr. Sherman, is recognized for 2 minutes.

Mr. SHERMAN. Yes, indeed, FHA's market share has grown, as the gentleman from California points out. That is FHA's mission, to step forward and play a larger role when we have a downturn, in this case the largest downturn in the housing economy in modern times. FHA has lost money on the guarantees that it made of mortgages in 2007 and 2008. Who hasn't?

Very few people realized we were headed for a huge decline in home prices. And even the most carefully selected mortgages made in 2007 and 2008 had a higher than expected default rate, as people became unemployed and as they were unable to sell their homes at a profit when they were forced to sell them by unemployment or divorce or whatever. Moody's Analytics estimated that if the FHA hadn't stepped forward, then by 2010 we would have seen another 25 percent decline in home prices around this country.

That would have been terrible for our economy, and even terrible for the private mortgage insurance industry. I look forward to restoring a more orderly market, one in which private mortgage insurance will be playing a bigger role, and FHA will be playing a smaller one, as we stabilize this economy and stabilize home prices.

Finally, I come from a high-cost area, where $729,000 is still a middle-class family. And to have Fannie Mae and Freddie Mac shut out of that market, but the FHA in it, I think is unfair to the private mortgage insurance industry. People with those mortgages ought to be eligible for a combination of private mortgage insurance and Fannie Mae and Freddie Mac. I look forward to restoring the situation where Fannie and Freddie have limits at least as high as FHA.

And I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman, Mr. Westmoreland, is recognized for 2 minutes.

Mr. WESTMORELAND. Thank you, Mr. Chairman. I have said this many times before: The FHA is insolvent. If FHA were a private mortgage insurance company or one of my community banks, it would have failed a long time ago. We don't want FHA to fail. We want it to do what it was created to do. Instead of focusing on fundamentals like shrinking their portfolio, reducing risk, and charging a premium that is in line with risk, FHA has advanced a policy that can only be described as out of bounds from its original intent.

In fact, the administrator admitted to this committee last month that people earning over $100,000 are eligible for an FHA loan. Are these the low-income borrowers FHA is supposed to be serving? FHA is in markets and arenas that they don't need to be in. Further, Dodd-Frank, the QM, and Federal housing policies are driving businesses to FHA rather than away from the private sector. The list of FHA advantages over the private market is long, and I have fought to bring private mortgage financing and PMI back into the market.

We need to reduce the 100 percent guarantee to 25 to 50 percent to be in line with the VA program and what private mortgage insurance offers. We need to reduce the loan limit to be in line with the area medium income, and tie FHA loans to the income. We need to restructure FHA premiums so that they can recapitalize their fund. And we need to be sure FHA uses the same standards for underwriting that are used in the private market.

I hope Chairman Hensarling and Chairman Neugebauer work towards a conservative bill that ends these subsidies and refocuses FHA on its core mission to serve first-time and low-income borrowers.

Thank you, Mr. Chairman, and I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentlewoman from Ohio, Mrs. Beatty, is recognized for 2 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member. I, too, join my colleagues in looking forward to continuing to discuss FHA's financial position and, in particular, the notion of government crowding out private mortgage insurance from the residential mortgage insurance market.

FHA has, indeed, become a much more significant player in the mortgage insurance market. But this reflects the fact that private mortgage insurers all but pulled out of the market during the housing downturn. According to Moody's Analytics, the FHA's response to the housing collapse prevented house prices from falling an addi-

tional 25 percent, which would have resulted in 3 million more jobs lost and a reduction in the economic output of $500 million.

So I think when we discuss FHA's larger market share, let's do so with a clear understanding of what precipitated this increased growth, which is first, the FHA's fulfillment of its statutorily-defined mission to promote long-term stability in the U.S. housing market by providing countercyclical support. Second, despite playing such a critical role in the crisis, the FHA has already begun taking steps to shore up the MMIF and to also refocus its efforts towards the primary market for FHA-insured loans, first-time homeowners, and low- and middle-income borrowers.

And lastly, by increasing, up front, annual fees, and making mortgage insurance premium payments due for the life of the loan, rather than just until the borrower's equity reaches a certain level, the FHA has actually strengthened the position of private mortgage insurances. And I certainly look forward to hearing from our witnesses today and continuing these hearings.

I yield back my time.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now the gentleman from Texas, Mr. Green, is recognized for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman, and thank you for allowing me to be a part of this subcommittee hearing.

I am here to say to FHA, "Thank God for you." I really do believe that FHA has been of great benefit to this country. It was formed at a time of crisis in 1934 when loans were hard to acquire, if you could acquire one at all. They were short-term, they had balloons. FHA was born out of a crisis with the intent of responding to a crisis, and that is exactly what it has done.

It has responded to the "Great Recession" by allowing people to acquire homes who probably could not have acquired them otherwise, given that so many of these other companies have gone out of business. If not for FHA, we would be in dire straits today. I believe that FHA can do some things to improve its position, and I look forward to tweaking it, and mending it, but not ending it.

Chairman NEUGEBAUER. I thank the gentleman. And now, we will recognize our panel. Each of you will be recognized for 5 minutes. Your written statements will be made a part of the record.

The panel today consists of: Mr. Ken Bjurstrom, principal and financial consultant from Milliman; Mr. Nat Shapo, a partner at Katten Muchin Rosenman; Mr. Brian Chappelle, a partner at Potomac Partners; Mr. Steve Stelmach, senior vice president and research analyst at FBR Capital Markets & Company; and Ms. Teresa Bryce Bazemore, president of Radian Guaranty, Inc.

Thank you for being here today. And with that, Mr. Bjurstrom, we will recognize you for 5 minutes.

STATEMENT OF KENNETH A. BJURSTROM, PRINCIPAL AND FINANCIAL CONSULTANT, MILLIMAN

Mr. BJURSTROM. Good morning. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the privilege of appearing here today.

My name is Ken Bjurstrom. I am a principal at Milliman, where my practice focuses on mortgage credit risk analysis for the mort-

gage insurance and mortgage banking industry, both for private and government organizations. In association with Milliman, I have conducted analyses of the private MI industry and, at the request of HUD's Inspector General, I have conducted several reviews of the actuarial report for the FHA's mutual mortgage insurance fund.

During the early 1980s and again in the early 1990s, as well as over the last few years, the economy has suffered declines in home prices or increases in unemployment resulting in mortgage insurance claims. Subsequent to each of these periods of economic stress, the MMIF experienced substantial losses. For endorsement year 1981, roughly 22 out of every 100 FHA borrowers defaulted and lost their home, resulting in a mortgage insurance claim to the FHA.

For endorsement years 1990 through 2003, relatively good times, the comparable rate was 8 out of 100 borrowers. And for the 2007 endorsement year, according to the FHA's MMIF actuarial report, the rate is estimated at over 30 out of every 100 FHA borrowers. All mortgage insurers are exposed to considerable risks which, in turn, require them to maintain basic disciplines, including underwriting, ratemaking, loss reserving, and also a commitment to high capital levels.

Historically, insurers have generally used the size of the downpayment or loan-to-value product type in the amount of coverage in their underwriting and ratemaking approach. Relatively recently, private MIs have expanded their premium rate programs to recognize the importance of borrower credit scores and other factors. In contrast, the FHA currently utilizes fewer tools available to them to manage their insurance exposures. Without a more granular approach to ratemaking, the FHA may be encouraging adverse selection with respect to obtaining FHA mortgage insurance protection.

State insurance laws require private MIs to adequately maintain multiple reserves. These reserve requirements require the MI to account for near-term expected losses, restrict shorter-term dividends, and measure the company's ability to write new business. The FHA, in contrast, does not have a comparable reserving methodology. Private MIs are generally subject to a maximum risk to capital ratio when combined with reserve requirements, require it to build reserves and surpluses during periods of economic growth so that they are in a position to cover substantial levels of claims during periods of economic downturn.

The FHA, on the other hand, is not required to hold equivalent statutory reserve requirements or comparable capital requirements. FHA's Mutual Mortgage Insurance Fund is required to have an independent actuarial analysis of its economic net worth and financial soundness to determine whether it has maintained a 2 percent ratio of the economic value to its insurance in force. This ratio requirement, and the economic valuation from which it is derived, is the only gauge of FHA's ability to withstand losses.

FHA's economic value calculation has several inherent weaknesses. The long-term forecast used generates significant positive economic value for the most recent endorsement years, as if these economic forecasts were certain. It considers anticipated future pre-

miums from these books and their future losses. But these recent books are very large and have the potential for significant variability over the long-term.

In contrast, private MIs do not take credit for the economic value reflected in future premiums and terms of their statutory requirements. If we were to re-look at history and forecasted FHA claim rates and the economic environments that caused them, it is clear that the FHA should establish a capital threshold that reflects a more risk-based probability of stress losses in the future.

Additionally, the FHA should be allowed to establish loss reserves and account for estimated loss liabilities prior to determining its capital ratio or other assessments of its financial strength. Loss reserves are a critical part of determining the actuarial health of any insurance fund, and should be part of the MMIF capital assessment to give Congress a more accurate view as to the capital adequacy of the FHA's single-family operations.

Since the early 1980s, when I began working in this industry, I have witnessed multiple economic downturns which created tremendous losses for both private MIs and government-run funds at both the State and Federal levels. It is therefore important to continue to work diligently to protect the FHA program. To that end, I recommend that the FHA evaluate and adopt many of the private MI statutory accounting provisions described above, better understand and modify their exposures to support their mission, and retain the necessary capital that is required to protect the program now and for the next economic downturn that will most definitely occur.

Thank you for inviting me and for your consideration of my views. I would be pleased to answer any questions.

[The prepared statement of Mr. Bjurstrom can be found on page 65 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Shapo, you are recognized for 5 minutes.

STATEMENT OF NAT SHAPO, PARTNER, KATTEN MUCHIN ROSENMAN LLP

Mr. SHAPO. Thank you, and good morning, Mr. Chairman, Ranking Member Capuano, and members of the subcommittee. Thank you for inviting me. It is a privilege to participate as the subcommittee performs its important work.

My name is Nat Shapo. I am a partner at Katten Muchin Rosenman LLP in Chicago. I practice mainly in insurance, litigation, and regulatory matters. I am also a lecturer at the University of Chicago law school, where I teach insurance law. And I was privileged to be the Illinois Insurance Commissioner from 1999 to 2003.

At the subcommittee's request, I have analyzed the FHA Mutual Mortgage Insurance Fund from a regulatory perspective. From what I found, based on GAO audits and other public record, the fund appears to have been, and to be, operating and overseeing in a manner that conflicts with basic regulatory principles.

Insurance is regulated in the United States primarily by the States per the Congress' direction in the McCarran-Ferguson Act. The State insurance department is generally divided into solvency regulation and market practice oversight. The former, solvency reg-

ulation, is usually looked at as the most important function of insurance regulation, since financial impairment jeopardizes the carrier's ability to carry through on the heart of the insurance contract, the promise to pay.

Nearly a century ago, the Supreme Court nicely explained the key place that solvency regulation has in protecting the well-being of the common fund that all consumers rely upon. Insurance companies, the court said, create a fund of assurance and credit, with companies becoming the depositories of the money of the insured, possessing great power thereby and are thereby charged with great responsibility. How necessary their solvency is, is manifest.

With respect to solvency regulation, requiring capitalization commensurate with risk is a basic pillar. Thus, a common requirement in the States, based on a National Association of Insurance Commissioners model, is a risk to capital ratio limiting outstanding liability on the insurer's aggregate policies to 25 times its capital surplus and contingents in reserve. In other words, the carrier must have real money, at least 4 percent of its liabilities, on hand.

The 4 percent capital to risk ratio is backed up in the NAIC model. If it is pierced, the carrier may not write new business. This protects both current and potential new consumers by preventing an impairment from becoming a catastrophe. The FHA fund's risk to capital ratio of 50 to one, which means capital in the amount of 2 percent of exposure, is half as stringent as the NAIC model's 4 percent. Certainly, the weaker standard is relevant.

But my bigger concern is that the standard, at whichever level, is not enforced, as a regulatory requirement, in practice. The GAO found that the capital ratio fell from about 7 percent in 2006 to 3 percent in 2008, below 2 percent in 2009. It is not expected to reach 2 percent again until 2017, meaning it will likely be below its statutorily-mandated level for 8 years. This extended failure to meet the legal minimum is exacerbated by the FHA's practice of attempting to write its way out of trouble.

An impaired insurer is generally not allowed to write new business absent very stringent additional requirements. But FHA's exposure has ballooned, according to the GAO. In 2006, FHA insured approximately 4.5 percent. Today, it insures at its peak, though in 2009, it insured 32.6 percent. Today, we are still over a quarter. The results have been predictable, and exactly what insurance regulation is designed to prevent; the deepening of the crisis, and a full-blown negative balance sheet.

GAO explained that in 2012, the capital ratio fell below zero, to negative 1.44 percent. The fund is expected to be in negative balance for at least 2 years. A private insurer in such insolvent condition would be put in liquidation. The commonly-adopted NAIC hazardous financial condition regulation establishes a number of other different standards that would be triggered by an insurer in the fund's condition, which I have covered in my written testimony.

Adverse findings in audits—we have seen that with the GAO. An insurer's operating loss in a 12-month period greater than 50 percent of the insurer's remaining surplus. The fund has no surplus. The insurer growing so rapidly that it lacks adequate financial capacity. The fund's increased market share by 700 percent, while turning into a balance sheet insolvency. So the fund would be in

violation of those basic standards of the NAIC hazardous financial condition regulation.

I was asked to provide a regulatory analysis, and the ultimate policy issues here are well beyond my proverbial pay grade so I will only briefly comment. Insurance is complicated, but its basics are straightforward. The Supreme Court explained that Congress understood the business of insurance to be underwriting the and spreading of risk. The fund operates apart from the basic rule. It does not evaluated hazards according to actuarial principles or correlated premiums-to-risk.

The capital in this common fund does not support its exposure. Government intervention in the distribution of risk never ends well, and does not ultimately protect consumers that it is meant to. We have seen that in the New Jersey auto market and other places with heavy government intervention. By doing so, FEIA makes obtaining business and attracting capital, the core functions of any business, more difficult for carriers, distorts the entire market as a whole, and deepens the spirals already in place both at the FHA and among private carriers.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shapo can be found on page 88 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And now, Mr. Chappelle, you are recognized for 5 minutes.

STATEMENT OF BRIAN CHAPPELLE, PARTNER, POTOMAC PARTNERS LLC

Mr. CHAPPELLE. Thank you, Mr. Chairman, Ranking Member Capuano, and members of the subcommittee. I am Brian Chappelle with Potomac Partners.

I believe that a strong and viable private mortgage insurance industry is an integral part of the mortgage market. I also believe that the MIs' challenges today have little to do with FHA. The MIs benefited from FHA's support of the mortgage market at the height of the crisis in 2008. By helping to stabilize home prices, FHA reduced MI losses. However, as the FHA audit shows, FHA will incur significant losses on loans made during that period.

The good news is that loans made since then have strengthened the fund. FHA has taken numerous steps to shore up its reserves. Its rate increases are also pushing more business back to the MIs. FHA has raised its premium 5 times, with another coming next month. Even an MI said, in its annual earnings filing just last week, "We believe that the FHA's current premium pricing has allowed us to be more competitive with the FHA than in the recent past for loans with high FICO credit scores."

And that was before the FHA's upcoming increase. For all the attention given FHA's mortgage limits, the data shows that FHA activity is concentrated in lower-priced homes. FHA's median loan amount was $147,000 in 2011. Seventy-one percent of FHA loans insured in 2012 were below $200,000; $200,000 is below the base loan limit in effect prior to the Economic Stimulus Act of 2008. Over 80 percent of FHA loans insured last year were also below the pre-stimulus limit when high-cost areas were included.

FHA did more loans under $50,000 than over $500,000. FHA did twice as many loans under $100,000 as they did over $300,000. Concerning borrower income, the FHA median was $56,000 in 2011. FHA's median was only 12 percent above the U.S. median family income that year. That is lower than FHA's borrower profile in 1971, 40 years ago, when the FHA median was 22 percent higher than the U.S. median.

There are three ways that FHA achieves the balance between its mission, its responsibility to the taxpayer, while also minimizing overlap with the private sector. First, FHA's premium structure reduces overlap. Unlike many types of insurance, FHA charges all borrowers the same premium regardless of credit characteristics, thereby helping the private insurers to compete for better-quality loans.

Second, FHA uses reasonable mortgage limits to minimize overlap. As the above data showed, high-balance loans are a very small part of FHA's business, or the MIs problem. However, some high-balance loans can help FHA cushion taxpayer risk because every audit I can remember has said higher-balance loans perform better.

Third, FHA provides 100 percent insurance coverage. A 1997 GAO audit concluded, "Reducing coverage would increase borrower costs and reduce borrower eligibility." In addition, lenders are now taking the unprecedented step of adding their own underwriting requirements on top of FHA's. Reducing coverage would exacerbate this current problem.

There is a more immediate problem facing the mortgage market today, however. As Federal Reserve Governor Duke noted in a speech last Friday, purchase mortgages hit their lowest level since the early 1990s. That is 22 percent fewer purchases than in 2008 at the height of the crisis. Younger home buyers are being particularly hard hit by tight credit. According to Governor Duke, from late 2009 to 2011, the number of first-time home buyers under 40 was half of what it was in the early 2000s.

She added that since 2007, there has been a fall of about 90 percent for borrowers with credit scores between 620 and 680. At the same time, about 30 percent of all purchase transactions in 2012 had home buyers paying cash. They did not need or want a mortgage. For the first time I also can remember, all cash sales are now the number one source for home purchases in our country, ahead of FHA, Fannie Mae or Freddie Mac.

In other words, the private sector has returned to the housing market, just not to the mortgage market. I am worried that we may well be moving backwards towards the housing market where homeownership is limited to those who are wealthy or have wealthy parents, and a dwindling few whose credit is stellar enough to qualify for a mortgage. I believe that we must first solve this challenge before worrying about carving up a depressed purchase mortgage market.

The fundamental problem with the current market today is not that FHA is doing too many purchase loans, but that, combined, FHA, the private mortgage insurers, and the GSEs are not backing enough of them.

Thank you very much, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Chappelle can be found on page 76 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Stelmach, you are recognized for 5 minutes.

STATEMENT OF STEPHEN STELMACH, SENIOR VICE PRESIDENT AND RESEARCH ANALYST, FBR CAPITAL MARKETS & CO.

Mr. STELMACH. Good morning. My name is Steve Stelmach. I am senior vice president at FBR Capital Markets, an investment banking firm headquartered in Arlington, Virginia. I would like to thank Chairman Neugebauer and Ranking Member Capuano for my invitation today.

Among the issues that the subcommittee asked to be addressed today is the impact of the FHA's policies and practices on investments in private mortgage insurance. This is a topic for which I can offer a unique perspective. In my role at FBR Capital Markets, I have 10 years of experience in advising our clients on the merits and risks of investing in particular industries and companies

My particular area of focus is U.S. housing, mortgage finance, and, relevant to the subcommittee, mortgage insurance. FBR's clients are pension funds, endowments, mutual funds, and asset managers in the United States and in Europe. Collectively, these clients match assets in the trillions of dollars. Having participated in countless conversations with these institutional investors over many years, I can attest that the actions of the FHA have a direct influence on investor decisions to allocate or not allocate capital to the private mortgage insurance industry.

Today, I would like to address three main topics on which investors tend to focus: first, how the FHA has historically crowded out private capital; second, how recent changes at the FHA has actually encouraged new capital into the market; and third, how FHA policy changes can have the impact of expanding mortgage availability.

First, on the issue of crowding out private capital, the FHA has a fixed insurance premium structure, which means the borrowers are all charged the same insurance premium. Until recently, that premium was at or below rates charged by private mortgage insurers. This premium, combined with the downpayment requirements, are less than those required by private mortgage insurance, higher FHA seller concessions, lower perceived repurchase risks for defaulted loans, and higher gain on sale margins pushed lenders and borrowers into the FHA product.

With capacity constraints within the mortgage origination channels, uncertainty of our future liabilities, the creditworthiness of the average FHA borrower is much higher than historical levels. Currently, the average credit score of an FHA-insured loan hovers around 700. This is safely in prime credit territory, and well above the average FICO score for many low- and moderate-income households that the FHA has traditionally served.

When the FHA premium was capped at 55 basis points, FHA charged a lower insurance premium for this prime quality borrower than premiums charged by the private mortgage insurers, making it exceedingly difficult for the private mortgage insurers to compete

for that business. Turning to the issue of private industry, or private capital returns in the mortgage insurance industry, we see investor interest as very strong.

Following the passage of the FHA Reform Act of 2010, the FHA was given the authority to raise annual premiums to 155 basis points, or 1.55 percent. Following a series of premium increases, the current FHA premium is 1.35 percent. Additionally, the FHA has taken further steps to shore up its finances, making FHA loans less attractive to higher credit quality borrowers, expanding the market share from private mortgage insurers.

Since the FHA began to institute premium increases in 2012, FBR has helped to raise $550 million in capital for a new mortgage insurance company, and recently participated in raising a billion in capital for an existing mortgage insurance company. In total, the mortgage insurance industry has attracted nearly $3 billion in new capital in the last 12 months. Notably, investors chose to invest this capital only after FHA instituted premium increases.

Despite the sums raised in the past 12 months, it is a far cry from the roughly $20 billion of capital that the private industry enjoyed just a few years ago. While much of the decline in industry capital is a result of extraordinary claims that the industry has paid in recent years, investors have been hesitant to provide capital to the industry, given persistent regulatory uncertainty, including GSE reform, FHA reform, Qualified Mortgage definitions under Dodd-Frank, and Qualified Residential Mortgage definitions under Dodd-Frank.

We believe that as the market receives greater clarity on these issues, this clarity can facilitate even greater investment in private mortgage insurance. As a public policy, it could be seen as self-defeating for the FHA to allocate precious dollars for borrowers who would otherwise qualify for private mortgage insurance, while other borrowers struggle to get financing. As a means of expanding mortgage availability to those less-served segments of our country, the FHA has a critical role to play.

And this dynamic leads to my final point. Higher premiums and other actions taken by the FHA can actually increase mortgage availability, up to a point. Now, this may sound inconsistent with policymakers' objectives but, in fact, we expect FHA premium increases to widen mortgage availability to less-served segments of our community. As premium increases take hold at the FHA, the FHA will price itself out of the prime credit market that I mentioned earlier.

Private mortgage insurers are willing to serve this market. And if the government backs away, investors are more willing to invest in this private industry. In fact, we have started to see this play out. Importantly, however, now that the FHA capacity is not being allocated to this higher credit quality borrower, the FHA's precious resources can be directed to qualified but less creditworthy households. Under this scenario, we see the FHA fulfilling a very important policy objective of providing mortgage credit to underserved borrowers, while private capital becomes increasingly available to meet growing mortgage market demand.

Again, I thank the committee for inviting me today. I am happy to answer any questions that you may have.

[The prepared statement of Mr. Stelmach can be found on page 99 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And finally, Ms. Bazemore, you are recognized for 5 minutes.

STATEMENT OF TERESA BRYCE BAZEMORE, PRESIDENT, RADIAN GUARANTY, INC.

Ms. BAZEMORE. Thank you. Good morning. I am Teresa Bryce Bazemore, president of Radian Guaranty, a leading private mortgage insurance company. For decades, FHA and private MI have worked together in housing finance to ensure that low- and moderate-income families could purchase homes, often their first homes, with low downpayments.

In fact, my first loan was an FHA loan for a condo, and so I have personally benefited from receiving both FHA and privately insured mortgage loans. FHA has been, and remains, a valuable part of the housing finance system. However, in the past few years FHA has dominated the mortgage insurance market due to housing policies and practices that provide competitive advantages to FHA, while crowding out private capital.

By way of background, the private mortgage insurance, or MI, industry is the private sector alternative to loans insured by FHA. Private mortgage insurers help qualified, low-downpayment borrowers obtain an affordable and sustainable mortgage. When a borrower places less than 20 percent down, the lender is required to obtain private MI in order for that loan to be eligible for subsequent sale to Fannie Mae or Freddie Mac.

Even during the recent challenging times, the MI industry raised over $8 billion in new capital, paid approximately $34 billion to the GSEs in claims resulting from foreclosure losses, and has reserved another $16 billion for this purpose. This is $50 billion taxpayers do not have to pay. We are able to pay claims at these levels in part because of the rigorous countercyclical reserve requirements and loan loss reserve requirements imposed by State insurance commissioners.

A requirement to reserve half of every premium for 10 years ensures that significant capital reserves are accumulated during good times, and then drawn upon to absorb the losses during downturns. While private MI and FHA are similar in that they enable borrowers to buy a home with less than a 20 percent downpayment, there are some significant differences that Congress should consider.

First, private MI places private capital at risk in a first-loss position after the borrower's equity. FHA relies on Federal funding, so that taxpayers currently are on the hook for over $1 trillion in mortgages.

Second, private MI covers 25 to 35 percent of the loan amount, whereas FHA insures 100 percent of the loan amount, meaning the lender lacks any meaningful risk of loss.

Third, private MI companies adjust premiums depending on the underlying loan characteristics. FHA premiums, on the other hand, do not reflect the true overall risk of the loans that FHA insures. Fourth, loans insured by FHA and guaranteed by Ginnie Mae are

priced more favorably in the market than conventional loans guaranteed by Fannie and Freddie and insured by private MI.

Keeping these differences in mind, I would like to offer five recommendations.

First, authorize risk-sharing between FHA and private mortgage insurers. The private mortgage insurer will conduct an independent underwriting, and take a first-loss position ahead of the taxpayer.

Second, alter FHA borrower eligibility standards to refocus FHA on serving lower- and moderate-income borrowers who need their help, as proposed in the Administration's February 2011 White Paper on housing finance reform.

Third, consider reducing FHA's guarantee below its current 100 percent level, much like the VA mortgage program. A lower level of insurance coverage results in better underwriting and loan performance, which reduces both the probability of default and the severity of loss.

Fourth, authorize FHA to adjust its premiums to levels that reflect the true risk of the loans that it insures.

And fifth, avoid government actions that unintentionally steer borrowers to FHA, such as GSE guarantee fees and loan level price adjustments that are not actuarially based.

The result is to make privately insured loans purchased by the GSEs more expensive than FHA-insured loans, thereby steering borrowers to FHA loans. Finally, I would like to say that unless the QRM and Basel III rules recognize private MI as a risk mitigant, low- downpayment borrowers will find it much harder to obtain a mortgage.

Thank you, and I will be glad to answer any questions.

[The prepared statement of Ms. Bazemore can be found on page 46 of the appendix.]

Chairman NEUGEBAUER. I thank the gentlewoman. And now, each Member will be recognized for 5 minutes for questions.

I will begin by recognizing myself for the first question. Mr. Shapo, according to the NAIC Model Act, and I am going to read from that, "In the event that any mortgage insurer has an outstanding total liability exceeding 25 times its capital, surplus and contingency reserve, it shall cease operating until it can build sufficient reserves." Why do you believe that State regulators put that in place?

Mr. SHAPO. It is part of the risk. The risk to capital ratio is a pillar of the system. There are minimum capital requirements in the low seven figures, but for a larger company, that is not the most important requirement. The most important requirement, as the company grows and as its exposure changes, the capital has to change and increase as the risk increases. So the baseline requirement is risk to capital.

The requirements in different lines of insurance all follow that, in one form or fashion, the risk to capital ratio. And so that is the baseline requirement. And then the most important remedy, the most important follow-up to that is that if you don't meet that ratio, you can't continue to write business. It is essential that a company that is not able to support its level of exposure with real money in hand cannot continue to write more business and, poten-

tially, increase and take basically an impairment and turn it into an—

Chairman NEUGEBAUER. So to if I am following you here then, if FHA were an insurance company in Illinois, where you were a former insurance commissioner, and they had a negative net worth and they were writing 52 percent of the business, would they be allowed to continue to do that?

Mr. SHAPO. No. The basic purpose of the regulation is to keep, is to try to cabin the risk. You need to cabin the risk because you need to protect the current policyholders, you want—you need to—

Chairman NEUGEBAUER. My time is limited. I intended for that to be a yes-or-no question.

Mr. SHAPO. I am sorry.

Chairman NEUGEBAUER. So would they be allowed to continue to operate in Illinois if they had a negative net worth and they were increasing the amount of business that they were getting?

Mr. SHAPO. No, the purpose would be to avoid the negative net worth. And so the answer is they would not be allowed to continue.

Chairman NEUGEBAUER. So I want to get consensus here because I think an important piece of this hearing is to establish what FHA is. And so, Mr. Bjurstrom, is FHA a mortgage insurance entity?

Mr. BJURSTROM. I believe it is, yes.

Chairman NEUGEBAUER. Yes. And so is it being run, and is the oversight consistent with other mortgage insurance companies in this country?

Mr. BJURSTROM. I think over the last 20 years, there have been several attempts to perform actuarial credibility as well as capital modeling. But due to the single-premium-fits-all type of structure, and the lack of actual reserving for losses, there is a lot of confusion with respect to how much the capital ratio or even just the capital account has in order to pay losses.

So if you look over the last 20 years, they have lowered their premiums. I think they began about 380 basis points about 20 years ago. They reduced them down, thinking that they had enough money after the last crisis. But we went into this next crisis in such a manner where now they are increasing premiums again. And it is that kind of fluctuation and lack of temporal diversification that creates a lot of confusion. Therefore, the standards aren't set and regulated enough in order for them to maintain a high enough water level to meet their expected claim liabilities.

Chairman NEUGEBAUER. And my final question—and I have asked this a couple of times in previous hearings. One of the concerns I have is, almost that FHA manages their fund based on cash flow. In other words, as long as they have enough cash flow coming in to cover the losses for this year, they kind of think they deem themselves sufficiently capitalized. And if you run business on that model, then you are not ready for the big hit down the road.

But the question I would have today is, I wonder what the numbers would look like. The fund is now underwater to the tune of about, I think, 1.7 percent or something like that. If they didn't have the current levels of business of the market that they have, if they had a more traditional level, would that number—you have done a lot of analysis—be much lower? In other words, their capital

would be actually more negative if they didn't have the cash flow day after day from the fact that they are dominating the market?

Mr. BJURSTROM. Yes, they operate on a cash basis, and they have operated in that manner until they actually—until they were held to hold a—to perform the capital ratio test. But the capital ratio test is just a number of financial strength. They still operate on a cash basis. So at the end of the day, there are roughly 750,000-plus serious delinquent borrowers right now. So that if they were to have to reserve immediately for those losses, and pull that cash into a reserve and then recalculate their capital ratio, you are correct that capital ratio, or financial ability to serve future borrowers, is much less.

Chairman NEUGEBAUER. I thank the gentleman.

And now the ranking member, Mr. Capuano, is recognized for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. And again, I thank the witnesses for your testimony. Thank you for being here today.

Mr. Bjurstrom, do you think the FHA should be shut down because it is bankrupt?

Mr. BJURSTROM. I do not.

Mr. CAPUANO. Mr. Shapo, do you think the FHA should be shut down?

Mr. SHAPO. No, sir.

Mr. CAPUANO. Mr. Chappelle?

Mr. CHAPPELLE. No, sir.

Mr. CAPUANO. Mr. Stelmach?

Mr. STELMACH. No, sir.

Mr. CAPUANO. Ms. Bazemore?

Ms. BAZEMORE. No.

Mr. CAPUANO. Good. We agree. Thanks for coming.

[laughter].

But we all agree that the FHA has some current issues. We all agree with that, no doubt, no debate. Mr. Bjurstrom, as I understand it, the FHA now has approximately $30 billion, give or take, in reserves. Do you believe that they will exceed those reserves in this year? Do you think they will dip beyond that, into taxpayer funds, to meet their requirements this coming fiscal year?

Mr. BJURSTROM. I think it will be close.

Mr. CAPUANO. Do you think they are going to need taxpayer funds this year?

Mr. BJURSTROM. No.

Mr. CAPUANO. Mr. Shapo, do you think they are going to need taxpayer funds this year?

Mr. SHAPO. Not to my knowledge.

Mr. CAPUANO. Mr. Chappelle?

Mr. CHAPPELLE. No, sir.

Mr. CAPUANO. Mr. Stelmach?

Mr. STELMACH. Not to my knowledge.

Mr. CAPUANO. Ms. Bazemore?

Ms. BAZEMORE. I don't have a basis to make that assumption.

Mr. CAPUANO. Fair enough. So of those of you who have an opinion agree they are not going to have to access taxpayer funds. Yet the law requires them to access that because the law, in my opinion, is stupid. Mr. Bjurstrom, do you think that law should con-

tinue? Do you think we should keep a stupid law, or do you think we should change a stupid law?

Mr. BJURSTROM. I don't have enough of a legal background to answer that question. I think that the—

Mr. CAPUANO. You learned from Ms. Bazemore, didn't you?

Mr. BJURSTROM. No, I think at the end of the day, the fund is the way—the accounting of the FHA is such that it relies on this water balance between the number of claims that they have to pay—

Mr. CAPUANO. No, I understand. They—I apologize, but my time is short.

Mr. BJURSTROM. Sure.

Mr. CAPUANO. I am not going to go through this because I think I just made the point that none of us think they are going to have to dip into taxpayer funds this year. I can't imagine that anyone would defend a stupid law, and therefore we should change a stupid law. And therefore, I invite my colleagues again to sign on to H.R. 1028, which will stop and prevent a stupid law from occurring and therefore exposing taxpayers to paying for something they don't have to pay for.

But we will see who actually signs on to that. I guess—what we are talking today is—I guess Ms. Bazemore, you have been in this business for awhile, correct?

Ms. BAZEMORE. Yes.

Mr. CAPUANO. Okay. Are all of the companies that were in business in 2007, all the PMI companies, still in business today and writing insurance today?

Ms. BAZEMORE. No. There were eight companies prior to the crisis, and three of them are no longer writing business. They are managing the portfolios that—

Mr. CAPUANO. So 3 out of 8 is what, 40 percent?

Ms. BAZEMORE. Five. So five are left. And three new entrants have come into the market.

Mr. CAPUANO. So approximately 40 percent of the companies have disappeared because of the crisis, and yet I am supposed to say when 40 percent of the companies have disappeared those losses have been probably been shifted over to government responsibility. And I understand that, I am not blaming them. Everybody lost money in 2008, a lot of people made bad assumptions and bad bets. But at least 40 percent of the PMI industry somehow made those same bets.

And yet, I am supposed to say everything was fine, we should just ignore that? The States can take care of it?

Ms. BAZEMORE. Actually—

Mr. CAPUANO. I think it speaks for itself, when you lose 40 percent of the companies doing the business, that there is an inherent problem that everybody has to share. I have no doubt that your business model has shifted today from what it was in 2007 and 2008.

Ms. BAZEMORE. I would just point that the loss reserves that were being discussed earlier, each of the companies that are—even though they are no longer allowed to write business, they had significant loss reserves to pay claims. So—okay.

Mr. CAPUANO. I understand that. And so is the FHA, obviously. So therefore, I understand that part of the reserve has worked. But they are out of business, so there is some problem. I guess I am trying to make the point that private insurance is a good thing. And I think that there is certainly a role for it, and I actually agree that it is upside-down now.

But I am looking at a chart that indicates in 2002, private insurance had 70 percent of the market and the FHA had 30 percent. Is that the right number? And in 2007, private insurance had 82 percent of the market and FHA had 18 percent. The question is, what is the right balance? And I guess we will find out as the market goes on. Today—in the last 2 years, private insurance had actually increased its share of the market by 2½ times. In 2008, did the FHA crowd you out?

Ms. BAZEMORE. I would say that the FHA actually didn't take actions to crowd us out. I think there were other government policies, such as the GSE increases in their fees, their LLPAs as well as—

Mr. CAPUANO. You do agree that we had to do something in 2008 and 2009?

Ms. BAZEMORE. Those two things happened in the 2008–2009 timeframe, and we saw a precipitous decline.

Mr. CAPUANO. Bingo.

Ms. BAZEMORE. And we have done a number of things as private MIs to get that business back.

Mr. CAPUANO. And I think that is fine. So has the FHA, and right now we are still in the process of trying to find that right balance, which I agree with. That is where I agree with the whole premise of these hearings, that we have to find the right balance, exactly where it is. But there is no given that somehow the FHA or government involvement in certain aspects of the market is a good thing. The question is, where is the line, let's fine tune it a little bit.

And by the way, before my time runs out, I just need to make the same point I always make, that when you talk about $200,000 limits, you are basically taking about a third of the country and saying we are not going to do any loans in your district. Because in Massachusetts last year, they had 83,000 FHA loans. Texas had 815,000. That is 9.7 times more FHA loans than Massachusetts did.

And if you limited it to $200,000, because the market in Massachusetts is so much more expensive, it would have been 24 times more loans. Because Texas is a relatively modest-priced State, and Massachusetts is not. And we are not alone. California, New York, Philadelphia. To understand the market, you have to understand there are regional differences in both real estate prices and wages. And I know you know that, but I say that because my time is running out.

Chairman NEUGEBAUER. I thank the gentleman. And that is one reason a lot of people are moving to Texas.

[laughter].

Mr. CAPUANO. Mr. Chairman, then why haven't our real estate prices gone down?

Chairman NEUGEBAUER. I now recognize the vice chairman of the subcommittee, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. The gentleman next to me from California is wanting all of those folks to come out to California, as well, so—thank you all for being here this morning. And to follow up a little bit on the ranking member's line of questioning there with regards to the size of the loans, the other day when we had the FHA individual in here talking about their model of how they were doing things, over the last couple of years they indicated that they have actually expanded the larger part of their—or the portfolio part of their business to making larger loans.

And they did it, they said, to—obviously, because of the increasing amount of premium they can get to shore up their bottom line. It would be counter to what I have heard this morning from, I think, two or three of you with regard to the data here that you are quoting this morning indicates that FHA actually has not been making larger loans in increasing numbers.

Can you give me some information? Mr. Chappelle, I know you were—you had a lot of information in your testimony.

Mr. CHAPPELLE. Thank you, Congressman. The Congress gave FHA the authority, in 2008, to expand its mortgage limits to help ensure there was liquidity in the entire mortgage market. Because private businesses made the decision, the smart decision, to pull back. But Congress wanted to make sure that there was money available so that the market would not collapse as far—worse than it actually did. And so, they gave the authority to the FHA to raise their limits.

FHA raised the limits. But the point is, they have done very few loans over $400,000; only 9 percent of their business is over $400,000.

Mr. LUETKEMEYER. Is it increasing, though? That was the point they made the other day.

Mr. CHAPPELLE. No, it is going the other way.

Mr. LUETKEMEYER. That they are increasing those numbers, and they are looking at the last couple of years of loans they have made. And they keep coming back and saying their portfolio has improved, our past dues are less, our loss ratios are less, and are pointing to that portion of their business as improving their overall picture.

Mr. CHAPPELLE. But the key issue is, structurally, in the FHA program, FHA charges every borrower the same premium. By charging every borrower the same premium, which some of my colleagues here aren't too crazy about—but by charging everybody the same premium, that means people with lower risk are paying more. It has been a fundamental part of every audit that I can remember that higher-balance loans perform better than lower-balance loans.

So by definition, if you are charging those borrowers here—if your premium is here on those borrowers, they are overpaying their premium. Consequently, they will go to the private MI because it is a better deal, unless they have no other choice. So the—

Mr. LUETKEMEYER. My comeback to that would be—I am not trying to argue with you here, but I—it is—I am getting some different information from those other folks who testified earlier. And having been in the financial services industry for 35 years, I can

tell you that, yes, the bigger loans, they may make more money on. But you also have more exposure to loss because there is a bigger loan there.

And if you don't have better criteria on those larger loans, and you don't do a better job of underwriting those loans, your exposure is greater. On the front end, you may make a few more dollars, but on the back end, your exposure is huge because it is a larger loan. If it goes south, you have a bigger problem. So I am not sure that they are actually solving the problem; I think they are probably taking on more risk in the long term, if that is the case.

But if you are saying they are not doing that, why, I appreciate your testimony this morning. From the standpoint of—Ms. Bazemore, you had some interesting comments here with regard to a number of suggestions on how to price risk and how FHA could improve their book of business. Could you go back over those? I thought some of those were pretty salient. And I guess my initial question would be, as you go through them, has FHA thought about doing some of these things?

Are you talking with them, do they have an ombudsman program, for instance, that you would be able to communicate with them on to be able to have some interaction and then have them take up some of these suggestions?

Ms. BAZEMORE. I would say that clearly they have made some changes in terms of increasing their pricing. I think part of it is just to understand what their risk is and making sure the pricing is commensurate with the risk that they are taking on. But with respect to risk-sharing, I think the concept there—which is something that we have had some engaged conversation about—is with the idea of being able to bring some of what we have built in the private mortgage insurance industry to bear in a way that would be really a partnership.

And we have built a lot in terms of risk analytics, we have built a lot in terms of our ability to analyze portfolios, even on a weekly basis, what is being submitted. And to communicate back with the lenders who are originating those loans to help them understand what is going on.

Mr. LUETKEMEYER. Thank you. My time is about ready to run out. I want to make one quick point. There are certain tenets of sound lending that are inescapable regardless of whether it is a large loan or a small loan. And if you get away from those sound tenets of lending, you are going to lose. It seems to me that we have continually done that with some of our GSEs. We continually—we know what we need to be doing, and yet we fall away from that. And then when—as soon as we do, we wind up in trouble.

Mr. Chairman, I yield back. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentlewoman from New York, Ms. Velazquez, is recognized for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Bjurstrom, following the housing bubble-burst, three of the eight largest private mortgage insurance companies went out of business. Those that survived suffered significant losses. Could you please explain the

reasons why many of the major private mortgage insurers suffered such losses during that economic recession?

Mr. BJURSTROM. I would be happy to. I think during that period of time there were a lot of new types of products that were brought to the market. And from an actuarial pricing standpoint, there was not a lot of information to judge the way they price their products. And therefore—

Ms. VELAZQUEZ. It didn't have anything to do with the fact that your industry relaxed the standards?

Mr. BJURSTROM. Yes.

Ms. VELAZQUEZ. Borrower standard and underwriting requirements, pressure by the lenders?

Mr. BJURSTROM. That is correct.

Ms. VELAZQUEZ. Okay. So why were some of these companies not able to pay these claims without going bankrupt?

Mr. BJURSTROM. Actually, they have been put into receivership and they have been under the department of insurance of their State of domicile. They are restricted from writing new business, but they are still paying claims and setting up reserves for those losses.

Ms. VELAZQUEZ. But still, can you explain to me why they were not able to pay the claims without going bankrupt?

Mr. BJURSTROM. Without going bankrupt?

Ms. VELAZQUEZ. Yes.

Mr. BJURSTROM. I think Mr. Shapo had indicated that they reached their statutory risk to capital.

Ms. VELAZQUEZ. Okay. Mr. Chappelle, Fannie Mae noted in its most recent report to the SEC that many of its private mortgage insurance counterparties were struggling to meet their current State regulatory capital reserve requirements. Based on your experience as a former insurance commissioner, would you be concerned about this company's current financial conditions? What about their obligations to fulfill future claims? Why or why not?

Mr. SHAPO. Why what? I am sorry, ma'am.

Ms. VELAZQUEZ. Why, or why not?

Mr. SHAPO. No. The purpose of the regulation is to keep the companies from going bankrupt. They are not bankrupt. The purpose of the regulation is to make sure that the risk to capital ratios are in line.

Ms. VELAZQUEZ. Would you please comment on the Fannie Mae recent report to the SEC?

Mr. SHAPO. I think I am commenting on it. What the States are doing is, they are preventing the companies from expanding their potential exposure at a time when their financial condition cannot support it. The whole purpose of that is to keep the companies from actually going bankrupt. They are not bankrupt. That is the purpose of requiring a minimum ratio. What has happened in some cases is the companies have been put in runoff, prevented from continuing to write new business.

They are put in runoff for the whole purpose of protecting the common fund and protecting the ability to pay clients.

Ms. VELAZQUEZ. Mr. Chappelle, recent reports from Fannie Mae on the Bank for International Settlements indicate that private mortgage insurers are still in a wait position and are susceptible

to significant risk. If private mortgage insurers were to obtain a larger share of the market as they claim they want, would they be in a good position to weather another economic downturn? Why or why not?

Mr. CHAPPELLE. That is a good question, Congresswoman. And it is an uncertain thing. None of the MIs have the rating that Fannie and Freddie required before the housing crisis, which was a AA rating. The good news is that the ratings are improving. But they are still well below an A rating, and that is a problem.

Ms. VELAZQUEZ. Thank you. Could you, Mr. Chappelle, discuss the importance of FHA's countercyclical role during periods of economic recession, when private mortgage insurers are absent from the market? How bad could the downturn have been if FHA was not present to keep the housing finance market afloat?

Mr. CHAPPELLE. Sure. I worked at FHA from 1975 to 1986, so I saw what happened in the oil patch States in 1982 to 1986. When we were at FHA, we continued to stay in those markets after the private sector made the right business decision to pull back. I remember a statistic that we had from back then, that 19 percent of FHA's business came from the 6 oil patch States, but 50 percent of their claims came from those 6 States.

Now, it would have been easy for FHA at the time to pull out of those six States. But if they had done that, it would have been devastating for Texas, Oklahoma, Colorado, Louisiana, Alaska, and another State. And so the value that played there is—what they are doing now is the same thing—at the national level, what it did in 2007 and 2008.

Ms. VELAZQUEZ. And can we talk about FHA solvency? Do you think that the agency has taken steps that will address its underlying solvency issue?

Mr. CHAPPELLE. Absolutely, Congresswoman. Their MIP for the period from the 1930s to the 1980s was roughly 3.5 percent, what they were collecting. They are now collecting 9 points today; 9 percent is their premium, effectively. That is going to allow them to shore up the fund immediately and build reserves so that hopefully, they will be above the 20 percent capital ratio much sooner than the actuary audit anticipated.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. MILLER [presiding]. Thank you.

Mr. Chappelle, you made a good point. Mr. Luetkemeyer made a statement, and he was correct, that when the larger loans do default, it is a large amount of money. But if you look at the reality, only 1.6 percent of FHA loans were made above $500,000; only 3.5 percent were made above $400,000; and only 9 percent were made above that range.

Mr. CHAPPELLE. Correct.

Mr. MILLER. But if you look at the default rate, above $400,000 the default rate was about 33 percent lower.

Mr. CHAPPELLE. Correct.

Mr. MILLER. As you go up, they even went down. So the FHA was right to a point. The loans they made that were the safest and best-performing are in the higher-cost areas, but they are not making that many of them.

Mr. CHAPPELLE. Exactly.

Mr. MILLER. Because of the cost.

Mr. Bjurstrom, you made a statement that their rates were much higher 20 years ago than today, but CDs were 6 and 7 percent 20 years ago, and they are less than 1 percent today. So everything has come down dramatically in that time.

But I am kind of curious how you perceive FHA's performance compared to the private sector in four ways: first, adequate internal controls and technology systems in place—how do they currently compare to the private sector; second, appropriate accounting standards; third, real-time risk management; and fourth, their capital ratios. Can you address those?

Mr. BJURSTROM. Yes. I think there is really—I can address it with two points. One is, is in any insurance company with respect to enterprise risk management, having a lot of change in any given year or over a very short period of time is never good. A few years ago, the FHA had a very low share of the market. And then as they came in, in the latter part of 2008 and 2009, they went from 400,000 policies to over a million policies.

That puts a lot of stress on an organization. So at the end of the day, working through that additional business puts a lot of stress—

Mr. MILLER. But that doesn't address the questions. Are their internal controls and technology systems, compared to the private sector, adequate? Are their appropriate accounting standards compared to the private sector, adequate? Real-time management? Are they responding in an adequate timeframe in their capital ratios?

Mr. BJURSTROM. Yes, I think their accounting needs to be changed to recognize the more certainty—certain liabilities that one can—

Mr. MILLER. So we need to provide better assets for them to make sure they can do their job.

Mr. BJURSTROM. That is correct.

Mr. MILLER. Okay.

Mr. BJURSTROM. That is correct.

Mr. MILLER. And how about their appropriate accounting standards and real-time management? Are they responding adequately today to the market changes? They weren't a year or 2 ago, but are they today? Have they upgraded their standards on risk management?

Mr. BJURSTROM. I believe they are working on it, to achieve a certain level of standards. But according to the GAO, I think there are a lot of improvements to be made.

Mr. MILLER. Okay. For everybody on the panel, do you think FHA operational technology and the cutting tools it needs are available to them today to minimize taxpayer risk? Ms. Bazemore?

Ms. BAZEMORE. I believe they need additional tools.

Mr. MILLER. Okay.

Mr. STELMACH. I don't have the ability to judge the FHA's internal—

Mr. MILLER. I couldn't hear you.

Mr. STELMACH. I don't have the ability to judge FHA's operations.

Mr. MILLER. Okay. Mr. Chappelle?

Mr. CHAPPELLE. They can always improve, but they are doing it at an acceptable level right now, I believe.

Mr. MILLER. Okay. Mr. Shapo?

Mr. SHAPO. I don't have the factual basis to be able to have a full answer to the question. But clearly, they are not—they do not have the same kind of enterprise risk management practices and self-assessment tools that regulated carriers do.

Mr. MILLER. Okay.

Mr. BJURSTROM. I agree with Mr. Shapo's point that the regulation is such a—in such a manner that those—that transparency is not there.

Mr. MILLER. Okay. Yes, sir—

Mr. CHAPPELLE. The legislation that this committee passed last year would go a long way to helping along that issue, though, also.

Mr. MILLER. Okay.

Ms. Bazemore, you commented on the lack of involvement of the private sector. And what I am seeing out there from people wanting loans is, the private sector is just not moving back in adequately. And the only option out there, in many cases, is FHA. That is the reality I see builders are going through when they are building homes and selling them.

And you say FHA premiums are harming the private sector return to the marketplace. They have increased them 5 times. So is it the premium problem, or is it the QM, QRM and Basel? All the private sector issues that we are trying to deal with, and we have made more difficult, are those keeping the private sector out more than just more the cost differential?

Ms. BAZEMORE. I think the first thing I would say is, you have to think of the private sector as sort of two parts. So when you think of private MI, we are really part of the GSEs. And so we insure GSEs, essentially bring private capital to that. That has always been there, we have never left the market. However, I think there was a perception with lenders in terms of going to FHA because that is where the decision is made about whether to use FHA or to use private mortgage insurance.

And so, for instance, over the last year we have trained 15,000 loan officers on the fact that many times it is better for the borrower to have a mortgage-insured loan than—

Mr. MILLER. No borrower with common sense would use FHA over private sector mortgage insurance, because of cost alone, if it were available. So, if you look at the cost differential between the two, it is huge. So if you are going to get an FHA loan, your fees and costs are much greater than if you went to a PMI in a private sector. So there has to be more keeping the private sector out than we are addressing.

Ms. BAZEMORE. You have to really look at the FHA and Ginnie Mae execution together, and that is the real comparison with MI and the GSEs. And it is still more favorable to have FHA and GSE, with a Ginnie Mae guarantee in terms of the loan in the marketplace.

Mr. MILLER. My time has expired. I would like to go into that more.

But, Mr. Cleaver, you are recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. This is one of the committees, I think, where there is an attempt to avoid having fact-free debates. So I would like to know whether any of you disagree

with the report from Inside Mortgage Finance which says the private mortgage insurance—insurers were able to write $175 billion in 2012. Does everyone agree with that?

Ms. BAZEMORE. Yes.

Mr. CLEAVER. So how do you juxtapose that with the subject of this hearing? FHA is crowding out the PMIs? Yes, Ms. Bazemore?

Ms. BAZEMORE. Congressman Cleaver, I think that a lot of the crowding out took place in sort of the 2009—late 2008–2009 timeframe. And since then, there have been efforts, I think, both by the FHA—because even Secretary Donovan stated that he felt they had too large of a share of the market. So FHA has taken steps, through premium increases. The private industry, private MI, we have also taken a number of steps to try to increase the share.

And I think that it is slowly working, and that is what you are seeing in Inside Mortgage Finance, that sort of has continued. The difficulty is that things like increased GSE fees, can have the effect of changing that. And so other benefits, when you see what is happening with QRM or Basel III—where FHA may get benefits—all of those things could actually reverse the benefits that we have been seeing. And that is one of the points of my testimony.

Mr. CLEAVER. Mr. Chappelle?

Mr. CHAPPELLE. Yes, I agree with your point, Congressman. The problems from the MI industry are not FHA-related. As Ms. Bazemore pointed out, it was QRM, it was loan level price adjustments from the GSEs. But also equally important, when you pull out of a market in 2008 and 2009, the mortgage business is a relationship business. If you pull out, you just can't flick a switch and come back in. It is going to take time.

And as Ms. Bazemore said, they are training loan officers about the benefits of private mortgage insurance. But I know a lot of lenders, going back to the oil patch days in the 1980s, who still have trouble doing business with MIs because they felt they had policies rescinded without having the coverage of insurance. So there are a lot of other factors that have nothing to do with FHA.

And, hopefully, the LLPAs are a critical—the GSE LLPAs are a critical part of that. And I know we agree that needs to be looked at. But it is far more of these other issues than it is the FHA issue.

Mr. CLEAVER. Yes, and if you listen to all of you, each of you has, at times, made statements that would suggest that you all agree that FHA is not the problem. But—and Ms. Bazemore, to go back to what you said, in 2007, the housing market collapsed. It collapsed. And so, these private companies did what they do at a time when things go bad. They pulled back. They stopped lending. Do you agree?

Ms. BAZEMORE. I don't think we stopped lending. I think, in fact, we changed our underwriting guidelines because we saw so many borrowers were being put into homes that they couldn't afford and we thought the loans should be affordable and sustainable. So many of the changes are in alignment with Dodd-Frank and QM.

Mr. CLEAVER. Yes. We probably have a slight disagreement. Because I think they stopped lending, and we actually had committee hearings where we dealt with that with banks. They stopped. And it is true that some of the exotic products had created problems,

and that was pushed aside as it never should have been brought to the surface.

But, there was some robust and reckless lending. Does anybody disagree with that? Okay. And so those companies—you can—I don't know how you want to—if you are going to say they came—that they had more intelligent lending. But the fact is, the percentage of the mortgage insurance written fell back, right?

Ms. BAZEMORE. Yes.

Mr. CLEAVER. So that, in and of itself, I think, would suggest the need to maintain FHA. I think we need to tweak a lot of things, including Dodd-Frank. But I don't think we can attribute everything bad to FHA. I am out of time.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman, Mr. Westmoreland, is recognized for 5 minutes.

Mr. WESTMORELAND. Thank you, Mr. Chairman.

Mr. Chappelle, I was noticing in your resume, or biography, that when you were with FHA you actually maybe had the responsibility for the development of the adjustable rate mortgage program. Is that true?

Mr. CHAPPELLE. Yes, I worked on the implementation of it. Yes.

Mr. WESTMORELAND. Okay. Originally, did FHA make that buyer, as part of the loan guarantee, qualify for the adjustable rate, or what the rate could eventually go to?

Mr. CHAPPELLE. We surely didn't use what it could eventually go to, Congressman. It was 30 years ago, so I am going to have to—I would have to go back and read the mortgagee letter.

Mr. WESTMORELAND. Okay. I was just thinking that you might remember it because it was a pretty important part, and you were there.

Mr. CHAPPELLE. The only thing I would say is adjustable rate mortgages are probably 1 percent of FHA's business today, a very small portion of it.

Mr. WESTMORELAND. Okay. But if you were making somebody qualify for what the rate could have been versus what the adjustment rate was, that would have been a smarter move, don't you think?

Mr. CHAPPELLE. Absolutely.

Mr. WESTMORELAND. Mr. Bjurstrom, you evidently counsel, I guess, businesses on how to compete against FHA. What are some of your recommendations that you give them to be able to compete, and what level can these private industries—do they play on the same level, the same guidelines, as what FHA does?

Mr. BJURSTROM. I think the MI companies try to price their products so that they achieve the amount of loss-paying ability and capital accretiveness that is necessary to remain a viable company. I think it is difficult to compete with one price that the FHA has with their—because it creates a sort of adverse selection between the products and programs that are being targeted for a capital accretive and solvent—on a solvent basis versus an all-in.

And from time to time it works out, but with one price for all borrowers over all times the underlying mix of the underwriting characteristics of the borrowers changes. So in some years, when

the economy is good, you may have additional premium because losses are low. But in times that it is bad, you have more losses, and therefore you are going to need more premium to cover those.

So to basically—the way I advise my clients is just to make sure that they understand the risks and exposures associated with originating a borrower, and then price it effectively.

Mr. WESTMORELAND. So, basically, are you saying that FHA may have some different guidelines as far as the quality of the credit?

Mr. BJURSTROM. Yes.

Mr. WESTMORELAND. Okay. Now, let me ask you this. And we agree—at least I agree coming from a building background, real estate background—that we need FHA. And FHA was started with great intentions as far as first-time home buyers, and low- to moderate-income. Do any of you on the panel see that FHA has gotten out of that original intent and gotten into some places where maybe the private sector, private mortgage insurance, has more expertise in that area of lending than what FHA was really created to do?

Ms. Bazemore?

Ms. BAZEMORE. I would just say that I think that while it is continuing to serve some of its historical mission, I think just because of some of these policies we have talked about, it has broadened out further than that. And a significant amount of loans that they are doing fall within what the private sector could be doing. And the capacity is there, certainly, to do it.

A comment came up earlier, just in the last 2 weeks, that two of our companies have raised $1.8 billion in capital. So the capacity is actually growing, and I think the model is working as it was intended to.

Mr. WESTMORELAND. Mr. Chappelle?

Mr. CHAPPELLE. Congressman, it is important to remember that the loans that the FHA is getting, these higher credit score borrower loans, are helping the solvency of the fund. But they charge a premium structure that discourages those borrowers from coming into the program unless they have no other option. So they are not—those borrowers are not getting a good deal because FHA charges that borrower the same price they charge the borrower with credit deficiencies.

So if they are coming in, they are coming in because they have no other option, because it wouldn't be the right business decision. But by the fact they are coming in, they are helping to strengthen the portfolio and the solvency of the fund.

Mr. WESTMORELAND. I am out of time. I will yield back. But I can appreciate that fact that they wouldn't be coming to FHA if they could go somewhere else. But to me, that is also a telltale sign of the quality of some of the loans that actually may be coming through.

So with that, I yield back.

Chairman NEUGEBAUER. I thank the gentleman. Mr. Sherman is recognized for 5 minutes.

Mr. SHERMAN. Ms. Bazemore, I was interested in your testimony on Basel III. I agree with you that obviously mortgage insurance is a risk mitigant. What can the Administration and/or this committee do to make sure that in calculating bank capital, the obvi-

ous risk mitigant effect of insurance, mortgage insurance, is taken into account?

Ms. BAZEMORE. I think the easiest thing to do would be to stay with what has been the current practice through Basel I of recognizing private mortgage insurance as a risk mitigant rather than the proposal that would not give any weight to it, but would give full weight to government loans.

Mr. SHERMAN. I would hope that this committee would join with you and others in the industry in making sure those who are crafting Basel III get that issue right. We all agree that we want private sector capital to be part of mortgage insurance. And I understand the private mortgage industry has recently attracted new capital. How much have you attracted?

Ms. BAZEMORE. Our company, about 2 weeks ago, raised a net $689 million. One of the other legacy mortgage insurer—insurance companies, in fact, just released today that they had netted, I think, about $1.1 billion. So just for those two companies, there was significant capital that came into the market.

Mr. SHERMAN. Now, are there changes that can be made in the FHA to increase the role of the private sector and to attract more capital into mortgage insurance?

Ms. BAZEMORE. I think the focus really is on moving FHA to more of its historical mission, understanding that may have changed over the last few years. And it is moving back, but looking at practices that really make sure that when private mortgage insurance is in the best interest of the borrower, it is being used. And that there aren't other sorts of decisions that are made, or policies that are put in place, that it would encourage otherwise.

Mr. SHERMAN. Now—and I don't know which person to address this to, so I will kind of see who seems interested in answering it—I understand that under the proposed QRM rule, loans insured by FHA are automatically exempted from the risk retention requirements, while loans insured by private insurance are not necessarily exempted.

Is this because meeting FHA standards somehow means that it is a wonderful, pristine loan? Or that the value of FHA insurance is so—that value means it is a Qualifying Mortgage, and why wouldn't we also exempt from the risk retention private mortgage insurance?

Always the same hands. I am used to that.

Ms. BAZEMORE. I think, first of all, the reason why FHA is given full credit is because it is fully backed, 100 percent explicitly, by the Federal Government, and so the banking regulators are essentially looking at that. I think that with respect to—there has been a huge coalition that has come together of industry, trade groups, and consumer groups that are very concerned about the QRM rule, because we believe that it could actually reduce the availability of low-downpayment loans.

And so, there has been a lot of focus on the fact that low- downpayment loans with MI should also be included in the QRM rule.

Mr. SHERMAN. So the reason for the exemption is not that FHA has standards that are so good that if you meet those standards it must be a Qualifying Mortgage. It is simply that if the lender

has that insurance, they are pretty well-insured from loss. Mr. Stelmach, I see you nodding.

Mr. STELMACH. I simply agree with Ms. Bazemore, that there is a 100 percent government guarantee on GMA securities, which are ultimately the destination for FHA loans. Those loans trade more—are more profitable to make than those in the mortgage origination market. And it makes more sense, perhaps, from a QRM definition. But it also will introduce distortions in market share between FHA and private capital, which may exacerbate the current situation.

Mr. SHERMAN. My time has expired.

Chairman NEUGEBAUER. Yes. Thanks to the gentleman.

And now the gentleman, Mr. Stivers, is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you holding this hearing.

My first question is for Ms. Bazemore. Do you believe that FHA underprices the risk that they insure? Because we talked about how they have gained a lot of market share from private mortgage insurance. PMI premiums have gone up because of the risk experience, but FHA hasn't gone up as much. Do you believe they underprice their risk?

Ms. BAZEMORE. Without doing a true actuarial review, it is hard for me to say at this point whether or not they are—

Mr. STIVERS. Let me ask it another way. Does private mortgage insurance charge an actuarially sound premium?

Ms. BAZEMORE. Yes, we believe we do.

Mr. STIVERS. Does FHA underprice PMI?

Ms. BAZEMORE. I think, based on the comparison, we would think that it is somewhat underpriced because of the risk profile of the loans that they are insuring.

Mr. STIVERS. I won't ask you take the next logical step, but everybody can do that for themselves. If PMI is actuarially priced soundly, and FHA underprices PMI, everybody else can do the rest of the equation for themselves.

One of the loss reserve accounts that are used by private mortgage insurance companies is the contingency reserve, where 50 percent of each premium collected from each given year's book of business is required to be held in reserve for a period of about 10 years to pay claims that might arise out of a specific book of business in the event of some kind of severe problem like we experienced over the last few years.

Which means private mortgage insurance can't earn all their premiums through short-term distortions in the marketplace of low default rates. Do you know if FHA follows that same reserving procedure?

Ms. BAZEMORE. That might be a better question for—

Mr. STIVERS. Does anybody on the panel know if FHA uses that same procedure?

Mr. BJURSTROM. They currently do not use that standard.

Mr. STIVERS. And if FHA doesn't have a contingency reserve, should it have one? I will go ahead and—we can go straight down the panel. Does everybody think that would be a good idea?

Mr. BJURSTROM. I think it would be a good idea.

Mr. SHAPO. It would be a sound way to manage risk in a way that they are not doing now.

Mr. CHAPPELLE. FHA does have $38 billion in reserve.

Mr. STIVERS. And what did they have last year?

Mr. CHAPPELLE. Thirty-three billion dollars, $32 billion. It has gone up.

Mr. STIVERS. Okay. Still going down there.

Mr. STELMACH. Yes, I believe that would be a sound practice, absolutely.

Mr. STIVERS. Thank you. The other thing that Ms. Bazemore talked about that I think is an interesting idea is to have partnerships with FHA and private mortgage insurance companies. Does anybody else on the panel—she was the only one who really spoke in depth about that. Somebody else mentioned it a little bit.

Mr. BJURSTROM. I have some—actually, there are examples of private-pubic partnerships now. A number of State housing finance agencies have mortgage insurance funds in which they actually reinsure 75 to 90 percent of the risk to the private MIs.

Mr. STIVERS. And do you think that is a good idea?

Mr. BJURSTROM. I do think—

Mr. STIVERS. I guess I want to go straight down the line again and see if everybody thinks that is a good idea. Because it sounds like a great idea to me.

Mr. SHAPO. In theory, it sounds like a great idea. I am not as familiar with the proposals as Ms. Bazemore and Mr. Bjurstrom.

Mr. STIVERS. Sure.

Mr. CHAPPELLE. I agree, Congressman. The Congress did give that legislation back in 1992, and the MI industry and FHA were both interested in doing it. But there are factors. The economic factors of pricing, counterparty risk, sharing of the risk, and never—nothing ever came of it back then.

Mr. STELMACH. I would agree that is a good idea. But we also need a balance between public policy and expanding homeownership with private capital. And that sounds a lot like some of the issues we had when the GSEs were in existence with trying to balance those same issues. So yes, a good idea, but balance.

Mr. STIVERS. Thanks. I think there are some ideas that we can pursue to have a more sound policy that charges actuarially sound rates, and still encourages homeownership. But when you encourage homeownership in a way that somebody can't sustain it, that is not really encouraging responsible homeownership. So I think charging rates that are inappropriate or low isn't fair to FHA or their long-term mission and their viability.

So I think there are some simple reforms that we can enact, common sense reforms, that I think would make the program better. I really appreciate all of you coming today. I appreciate your thoughtful testimony and ideas.

Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentlewoman from Ohio, Mrs. Beatty, is recognized for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member.

Mr. Shapo, I believe you stated in your testimony that the FHA has expanded its business in a time when it is—I think it was impaired, insolvent and undercapitalized. With that said, what do you

make of the fact that since its peak in 2009, FHA's market share has been steadily declining while the private mortgage insurance share has been increasing at roughly the same pace?

Mr. SHAPO. I think that the more important question is what would—the way I look at it is, what would happen—what would the ratios be now if it were not for the distortions to the market. The fact that FHA has reserves doesn't mean that it is not impaired and it doesn't mean that it is not in a negative position.

The fact that the FHA—that the loss history is improving doesn't mean that it should have continued to write more policies after it went under its minimum ratio and after it went into a negative balance. By doing those things, by expanding beyond its position before, it has distorted the marketplace. And so the question would be, would the private companies have been able to take a larger market share if they had been able to get some more of that good business that FHA was able to get after the worst of the financial crisis.

So I think that—my answer is, is that even though the private carriers have more market share, they do not necessarily have any market share that they could have gotten in the market share that could have properly supported their risk if there hadn't been distortions in the market.

Mrs. BEATTY. Mr. Shapo, with that said, maybe a better question, or response, would be if I put it this way. If you take, for example, the credit ratings, which I am sure we will all agree plays a key factor—so if you look at the world out here of the market share, and I have a credit rating that is on the high end. And if I then look at what the percentage cost for that loan would be, if I have a high rating and I am getting it for 4.3 percent, why would I then go to FHA, which is going to be a higher rating if my credit rating is a good rate?

So then those who would be in that same market share, with the higher—why would they go to FHA? You would, in fact, get those folks because most of us would understand a lower percentage, which you would get in the private market versus FHA. So I don't get that FHA would be hurting the private market, or insurers, because I am not going to pay 1.5 percent higher when I know I can come over here.

It tends to be into FHA's mission, which I am glad we agree on and we have heard in the other hearings, what their mission is core to. So those folks who fall to the left of the higher end are paying that flat rate because they are not going to be engaged with the private insurers.

Mr. SHAPO. My take on it would be that because of the—FHA has brought artificial factors into the starting—during the crisis. And then if it does so, it is going to be in a position to take those better risks because it has become a larger player. Therefore, keeping the private companies away from getting those better risks when the market got better probably affected their ability to attract capital.

They have attracted capital. But the question is, could they have attracted more capital? The mortgage insurance market, like all insurance markets but in particular the mortgage insurance market, is subject to pretty substantial fluctuations. And so the question is,

would the degree of the comeback been higher if there hadn't been as much distortion to the market between the government—

Mrs. BEATTY. I guess for me, it is not the distortion. And rest assured that I am comfortable in saying FHA does not set the credit scoring. So based on those folks going in on—the credit scoring is not established by FHA. They would not go to FHA when they can get a better rate.

Mr. SHAPO. But FHA's market position, I think, has distorted the market and restricted the ability of the private carriers to take in—to get the better risks, and then to attract more capital.

Mrs. BEATTY. I think we just have a difference of opinion. Thank you.

Chairman NEUGEBAUER. I thank the gentlewoman.

Now the gentleman from California, Mr. Royce, is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. Mr. Chairman, I think we have had a very good round of hearings on the future of FHA. It is not my goal to do away with FHA, but I do think we have to force the FHA to deal with its fiscal woes. We have to stop attempting to grow out of that situation with the approach that they are on now, and figure out a way to allow the private market to regain market share.

And when you think it through, I think that is the best scenario that we have for the taxpayers, but also for future homeowners if we can do that. I think we have already pretty clearly established that current policies at the FHA have led to the crowding out of the private market. So the concern here is, in the future, going forward, are there policies that are going to further aggravate that situation. And specifically, the proposed Qualified Residential Mortgage rule and the proposed Basel III capital rules provide special dispensation to FHA loans.

The former gives a safe harbor from the risk retention requirements for FHA loans, and the latter allows a zero-risk weight to loans insured by FHA. So the net result is that government policies, I presume here, are going to steer borrowers to the FHA and further crowd out the private market, which certainly was not the congressional intent. What will be the impact, is the question here, on the mortgage insurance marketplace if these rules are finalized in their current form?

And I would ask Mr. Bjurstrom and Ms. Bazemore for opinions on that.

Mr. BJURSTROM. I think the execution gets incredibly more expensive, and therefore the alternative FHA programs will dominate the market.

Ms. BAZEMORE. I would agree with that. I think that the concern is that the cost will become significantly higher, and so FHA would again be favored in the marketplace.

Mr. ROYCE. Would anyone else like to weigh in on that scenario, or do you agree with that assumption, or—

Mr. CHAPPELLE. I agree, Congressman. And I think it is important for private MI loans to receive the same general—be in the same general category as FHA or Fannie-Freddie loans are. Because we need more loans being made in the country, and we don't

need anything that is going to restrict or leave out loans. So I would heartily endorse it.

Mr. STELMACH. I would endorse that, as well. If you think about a $9 trillion mortgage market in the United States, there is only one industry right now, private industry, that provides some sort of credit enhancement with only $6 billion of capital to support that. So in a $9 trillion market with only $6 billion of private capital, I think there is ample room on a regulatory basis, on a Basel III basis, to expand that private capital.

Mr. ROYCE. Mr. Shapo, you say in your testimony you have seen many times, in the insurance marketplace, when government programs like residential risk pools put in place to try to help hard markets have ballooned in market share and only ultimately distorted the market and destroyed any chance the market had of pulling out of a crisis. And you cite the New Jersey automobile insurance markets as an example there.

That appears a good reference point for what we see now with the FHA, with market share rising I think it is about 56 percent or over that. And private insurers pressed to leave the market. As you say, this is just one of many examples of government intervention in the marketplace. Can you describe, then, the impact that this has on competition as a result of these interventions? Could you explain the result to consumers, and what other examples are out there that you might want to give us?

Mr. SHAPO. Thank you, Representative. Yes, the common thread in all these is substantial government intervention. Sometimes taking different forms, but substantial government intervention to try to enhance availability and/or affordability of insurance products. And my point is that an insurance market is like any other market. Insurance has many complexities, but the basic ways that the market works are not complex.

I quoted the Supreme Court, which quoted a House report, in McCarran-Ferguson: "The theory of insurance is the distribution of risk according to hazard, experience and the laws of averages." It is pretty straightforward stuff. And to the extent that the outcomes are not pleasing to policymakers, and that they try to affect those outcomes, that will affect the ways the market works.

Subsidies will develop, risk will be mispriced, capital formation—

Mr. ROYCE. Capital formation will be impacted negatively.

Mr. SHAPO. I'm sorry?

Mr. ROYCE. Capital formation is impacted negatively.

Mr. SHAPO. That becomes the most important factor, is that capital formation is negatively impacted. Money does not flow to the marketplace. And what happens is, you tend to get a double spiral. You get a spiral in the government-encouraged pool because it is not properly pricing risk. So it tends to balloon out of—and we have an extreme example here, where you have a negative cash balance and a negative capital position with the FHA program.

Mr. ROYCE. It can lead to insolvency, yes.

Mr. SHAPO. And it impairs the private market, too, because no capital comes in and they can't properly compete.

Mr. ROYCE. Thank you. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. Now, the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. I thank the chairman. I just have a couple of questions.

Mr. Bjurstrom, can you talk to me about accounting? GAAP accounting?

Mr. BJURSTROM. I am not an accountant, but I will do my best.

Mr. GARRETT. Is there any reason why the FHA could not be using GAAP accounting?

Mr. BJURSTROM. I don't—I believe they can account for it any way that you direct them to.

Mr. GARRETT. Okay. Is there any reason why other agencies or entities should not be using GAAP accounting, on the Federal level?

Mr. BJURSTROM. I am not familiar with the ability of other entities to do that.

Mr. GARRETT. All right. But as far as the FHA?

Mr. BJURSTROM. No, I believe that you have the ability to tell them specifically how to account.

Mr. GARRETT. Okay. So when you talked about the GSEs previously, you talked about them having stakeholders, which would be the investors in it, right? Now when you talk about the FHA, we don't have investors in the FHA in the typical sense of the word. But you do have shareholders, you might say, if you described the American taxpayer in the FHA.

And I guess this is open to the panel, as the taxpayer being the shareholder of the FHA, should we not be looking to them to factor in market risk, FHA, when they make their—when they do their accounting? I will start at the end, and anybody else who wants to comment on it.

Mr. BJURSTROM. Pricing is the art of factoring in all risks. And if you look at the exposures and the mission and the purpose, and then after you have figured that out and then you then back into pricing. And along with that pricing is a component for volatility, which would include a lot of the market risk which this industry has a lot of market risk volatility.

Mr. GARRETT. Right. And—so anybody else? Wouldn't that be more transparent if it was a private corporation? You would be requiring transparency to the investor. Here, the stakeholder is the taxpayer. So wouldn't that be good for the stakeholder, the taxpayer, to have that information, that transparency? Does anybody disagree with that? You disagree with that.

Mr. BJURSTROM. I like the transparency question just because of the fact that instead of it just being a single entity like the FHA pricing its own insurance, I think that is where they need to start. But I also like the benchmarking against others that are pricing for the same risk.

Mr. GARRETT. Right.

Mr. BJURSTROM. As well as the opportunity to do reinsurance or risk share. Because then you get many multiple points of validation that you agree with others that your price is commensurate with the risk, not just individually promoting price changes individually.

Mr. GARRETT. I understand. Mr. Chappelle, do you disagree with the idea of transparency?

Mr. CHAPPELLE. I don't disagree with the idea of transparency, but I do have trouble—FHA is a government program. If you are

going to compare it to the private sector, it is impossible to come up with a legitimate comparison. You are going to have to make estimates as part of that process. There was already a say to evaluate FHA's soundness through the 1990 Budget Act.

And if you want to move the goal posts and change how they do it, you could do it. But it is a government program. I think we all recognize that, and it is hard to apply to a government program what the private sector has. They don't have the profit motive. They can't withdraw from markets. They can't do the things the private sector—

Mr. GARRETT. Right. So you take that out. But as—your initial testimony was that you can factor in the market risk. So that would be one aspect that GAAP accounting would be providing to the public, the taxpayer, to understand better what their actual financial posture is. Notwithstanding that they don't make a profit, and notwithstanding that they are backstopped, correct?

Mr. CHAPPELLE. It wasn't my testimony that said that.

Mr. GARRETT. No, I am just saying would that—is that not true?

Mr. BJURSTROM. I think, at a minimum, doing the analysis in order to create the right policy and the right information concerning that policy is most appropriate.

Mr. GARRETT. In my minute that I have left here, the role of FHA, what it should be, what it was designed for. The President has talked famously about how we should be raising taxes on the proverbial rich. And they define the rich as those people making over $200,000, $250,000. If that is the rich, then should the FHA be put back to its original foundational format to say that it is not there to help the rich, it is to help out first-time homeowners and lower- and middle-income people making under $250,000?

Does anybody disagree with that assessment? You do?

Mr. CHAPPELLE. Congressman, it is an insurance program.

Mr. GARRETT. Right.

Mr. CHAPPELLE. And like everybody has said on this panel, it has to spread risk. There is a cornerstone of the FHA program that higher-balance loans perform better than lower-balance loans. So if we are going to protect the taxpayer, you need some of those borrowers. But the news is, FHA charges a premium structure that if someone who is "rich" wants to use the program, I would welcome it. Because they would be overpaying their insurance.

Mr. GARRETT. That is—okay, just to know, then, that we will establish one program that is for the rich, then, yes. That is fair.

I yield back, I guess. It is the Chair's prerogative.

Chairman NEUGEBAUER. I thank the gentleman.

I want to follow up here because a couple of points have been made. This hearing is really about a number of things, but one of them is that—and Mr. Chappelle just made this point—this is an insurance program. But it is an insurance program that is not being run like an insurance program, in that when you look at the industry standards that governments have basically established for people in this kind of business, model legislation, models of how much leverage is—should be—is reasonable, and reserves that should be there to protect people.

So I think the question is, is why would there be any argument that if we are going to have an insurance program, and the share-

holders are American taxpayers, why wouldn't we run it like an insurance company and have it adhere to the same standards that other insurance companies have to adhere to? Mr. Bjurstrom?

Mr. BJURSTROM. I agree. If you need to run it like an insurance program and price it appropriately, reserve for it appropriately, and capitalize it appropriately, then you would have a better idea of what your future expected outlook looks like. And that is really the—from a financial, accounting and modeling and actuarial standpoint, that is all we are really suggesting and trying to achieve.

Chairman NEUGEBAUER. I think the other issue is—and I support what the gentleman from New Jersey said about using GAAP accounting or what I call "accrual accounting" to be able to establish what is the value of the portfolio and what is the potential risk of the portfolio so that you can price it.

The other piece of the pricing currently is the fact that FHA doesn't factor in their operating costs into setting their price because we appropriate money for that. So at the very least, it would appear to me that if you are going—that entity should be at least, if it is not going to pay a dividend, if it doesn't have shareholders, it is going to operate as a nonprofit, it ought to at least, then, have to factor in the cost of operation.

Because it is not so much that we are trying to steer business to the private mortgage insurance companies, but what we are trying to do is find a balance in the marketplace of the total housing finance picture. And while we may be pushing some more business to the PMI companies, the private companies, today, unfortunately, about 90 percent of the mortgages in this country are still being backed by the American taxpayers.

And so it is the policy that we are driving, that we continue to, I think, put inhibition—or inhibit the ability of the private sector to be into the marketplace today. Because this has been brought out, the risk retention issues. But it is not so much the pricing differentiation of the premium law. That is a piece of it. But it is the fact that, overall, a FHA loan today is a lower-cost loan overall because of the fact that it is backed by the Federal Government.

And so when—and Ms. Bazemore brought this point up—you put the fact that you have Ginnie and FHA together, then the borrowing cost in the capital markets is much less. And so, it pushes it automatically. It doesn't—really, almost to a point where the differentiation in premium maybe is negated by the fact that the overall lower borrowing cost is compensating for any premium differentiation in the marketplace.

And so, I think one of the things that I would hope, as we are moving forward, is that we have two responsibilities here. One is to make sure that a program that we have oversight over as a government is being run appropriately. And that if we take a look at something that has been in place for a number of years without—not a lot of changes, and understanding that the world has changed. Back when FHA was originally put in place, there wasn't a lot of securitization going on.

Most of the loan sales were individual sales. Now we have securitization, so should we take a look at how we—how that impacts the way we run these businesses? But more importantly, I

think, for many of us is trying to get back—and I think Mr. Capuano made a great point earlier—what is the right formula. What is the role of—what is the marketplace for FHA? And then what is the marketplace for the private market to be in there?

We have to fix all of the pieces. But we can only fix them one at a time. And so as we move forward, I hope that we can have a meaningful dialogue about how we look at the FHA piece. I think there is some room here to shore it up, and I think there is room here to make sure that we don't—that there are not some market distortions there that are driving people to FHA other than the mortgage premium, or mortgage insurance premium, that FHA is charging.

And I think that is really, hopefully—we heard some very good testimony today, and I look forward to probably having some ongoing dialogue with some of the market participants here. Because the ultimate goal here is for all us to do the right thing. And I am concerned right now that we are running FHA kind of on an ad hoc basis. And if it had a little better structure that overall it would be a more sustainable program.

We wouldn't need to have hearings about why you have a negative net worth. Those are not the kind of oversight hearings that we need to be having. We need to be having oversight hearings where things are getting better. And unfortunately, we have been told that things are getting better, but the results have not proven that fact. And then the other point is the fact that since we are not using Generally Accepted Accounting Practices, we really don't know if this entity is actuarially, how sound it is or isn't.

So with that, I am going to yield to my colleague, Mr. Capuano, for any remarks that he may have.

Mr. CAPUANO. Thank you, Mr. Chairman. And again, I agree with you. I think that the whole idea of this is try to figure out exactly what we want the FHA to do. But I do caution people that no government program should be run as a private program. We don't have the profit motive. And if you want to look at the model, look at the model of private insurance, private mortgages before the FHA.

There were no middle-class mortgages, period, end of issue. Only rich people or people who inherited a house could afford to buy a home. And the FHA allowed people to get into the middle class by buying a home. So there is a balance. And I agree, our job is to try to find that balance. Ms. Bazemore, if I told you that in 2 years you could increase your share of the current business by 2½ times, do you think that would be a good deal?

Ms. BAZEMORE. Yes. But it would also depend on where I started.

Mr. CAPUANO. No, and I don't blame you. Of course, if you told me you were going to increase my salary 2½ times, I would say okay, I am in, sign me up. It's not happening, I know. PMI has increased its share of the mortgage businesses by 2½ times in the last 2 years. And yet I keep hearing from some people that it is absolutely proven, without question, without a doubt that the FHA is squeezing private enterprise out.

I find that hard to believe when you are increasing your mortgage here. You are going back to what appears to be a more normal time. We are not there yet. And I agree with that, there needs to

be more done. And my fear is that if we don't get this right, if we allow the FHA to continue going where it is going, which I don't like some of the things they have done. I understand them in the short term, but in the long term we will be doing, effectively, what we shouldn't be doing, which is making mortgages so expensive or mortgage insurance so expensive, again, there will be no middle-class people.

I guess I just want to reemphasize that as we rebalance this, as we look at it, the basic question is, how much is enough? And maybe I am wrong, but I don't think that the private mortgage industry would be well-served if we drive the middle class out. You have done a good job over the years finding a niche in balance with the FHA. Now, again, that niche, that whole system, was messed up in 2008 for everybody, and we need to re-find that balances.

But prior to that, I didn't hear any complaints. No one was complaining then. And so the question is, do we or do we want to have any government involvement in allowing the middle class to continue being able to afford a mortgage. And for me, that is where we are trying to go. I have no philosophical viewpoint here, except that I know—and again, I never qualified for an FHA loan because I do come from a high-cost area and because I have been fortunate in my life.

Fine. But I know one thing. If there were no GSEs and there was no FHA across the country, my mortgage rates would be through the roof and I never would have bought a home. Because I own, currently—the home that I bought in 1980 is a two-family home. Why did I buy a two-family home? I needed the rent to pay the mortgage. And I had to fight with the bank to accept that.

So without that, I wouldn't be in the middle class, and my children would not have had a college education because I, like many Americans, remortgaged my house to pay for their college education. And for me, I thank God there was a system in place that allowed me the opportunity to buy a home. And I need to make sure that is the case for the next generation. Which, by the way, as a point of fact, is not there in many parts of this country today.

People 30, 40 years old cannot afford to buy a home. They can't get the downpayments together because the house prices are too high, and they can't afford the monthly mortgage. Especially if you add that on top of the student loans they are paying. That is not good for them. It is also not good for America, and it is not good for your businesses. So with your help, we will find that way to balance it.

But I need to make sure that some philosophical viewpoint of some greater good doesn't get in the way of actually finding a way to rebalance this system in a manner that keeps it going for the next generation. I know that your testimonies I heard today all fit in that category, and I thank you for that. And I look forward to working with you all as we move forward.

Thank you.

Chairman NEUGEBAUER. The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you very much. And I neglected to thank the ranking member earlier for allowing me to be a part of the hearing. I did thank the chairman, so I now thank the ranking member.

And after hearing the ranking member's statement, I think we probably are at the offertory and closing hymn. Because like him, I, too, thank God for FHA.

But I will ask a few questions, if I may, to bring a little bit of clarity to your testimony. Because I suspect that some things are the case, but sometimes when you finish testifying, persons who are viewing this at home are not sure. So perhaps we can bring a bit of clarity. Is it true that each of you would keep FHA? Simply put, is there anyone who wants to end FHA, have no FHA at all?

If so, would you kindly raise your hand if you want to end FHA? All right, let the record reflect that we have no hands in the air. And as a result, we can conclude that no one wants to end FHA. Now, let me go further and ask is there anyone who believes that FHA as it has functioned traditionally is somehow adverse to the market that has developed through the years, that has seen some difficult times as of late. But is FHA's traditional role one that we all believe is important and we should maintain.

And if so, if you do not agree, would you kindly raise your hand? If you don't think its traditional role is one that we should maintain. And for our benefit, Mr. Chappelle, I am going to ask you to give us your summary, quickly, of what FHA's traditional role has been and how that role still benefits us, even in these difficult times.

Mr. CHAPPELLE. Sure, Congressman. FHA has helped low-, moderate- and middle-income families to be able to buy their home. Predominantly first-time home buyers; 75 to 80 percent of their loans go to first-time home buyers. Predominantly lower-income home buyers, as I noted in my testimony. Their median income was $56,000 in 2011. So FHA's role is to help—it is really the insurer of last resort for creditworthy home buyers.

But to be able to do that, they do need to spread that risk a little bit because they have to—they can't just have the highest-risk pool. They have to spread the risk. But they do have structural protections, I believe, which ensure they do not encroach too far into the private sector. And that would be the fundamental point I would make.

Mr. GREEN. And do you think that tweaking the 100 percent rule—that is what I am calling the rule that allows FHA to insure the home for 100 percent—

Mr. CHAPPELLE. —of the value?

Mr. GREEN. Of the value, yes. Do you think that can be tweaked such that it provides FHA with a greater amount or lesser amount of risk?

Mr. CHAPPELLE. I think it would be a major mistake for the program. That 100 percent insurance is one of the core, structural parts of the program. Because what is happening today in the marketplace is that lenders, even with 100 percent insurance, are adding their own underwriting requirements on top of FHA's. They are called "credit overlays." Because—and I know some of the panelists said there are only perceived risks in the FHA program.

I can assure everybody, lenders feel there is real risk in the FHA program. That is why they put these overlays in place. And if you go and lower that insurance from 100 percent, that is just going to ratchet up that risk factor for the lender, which will exclude the

people that you would like to see, and we would all like to be—see to be part of the FHA program. So I think that would be a serious, serious problem for the program to lower that insurance.

Mr. GREEN. And the final question on this—in this area. What do you think that FHA can do to better serve the public?

Mr. CHAPPELLE. Congressman?

Mr. GREEN. Yes. Mr. Chappelle?

Mr. CHAPPELLE. I think the mortgage limits were raised in response to the problems in the marketplace in 2007 and 2008. I, and I am sure most other people who would like to see the FHA program continue to prosper recognize those limits should not stay there forever. And once the mortgage market recovers—because the purchase market is still in a depressed state. But once the purchase market recovers, those limits should come down to more reasonable levels.

And I think at the appropriate time, that would be the correct thing to do.

Mr. GREEN. I thank all of the witnesses, and I will just have my parting comment. I have many constituents who have benefited from FHA. And it is the bridge that has brought a good many people over to the promised land, if you will, of homeownership. And I think that there may be some things that we can do to tweak it, but FHA should not be frowned upon for the good job that it has done.

And to a certain extent, we are condemning it for being successful. Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentleman. I would like to thank each of our witnesses again for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, the hearing is adjourned.

[Whereupon, at 12:17 p.m., the hearing was adjourned.]

A P P E N D I X

March 13, 2013

Statement of Randy Neugebauer
Subcommittee on Housing and Insurance
"Mortgage Insurance: Comparing Private Sector and Government-Subsidized Approaches"
March 13, 2013

Thank you all for attending this hearing examining FHA's role in the mortgage insurance market. This is the third in a series of hearings on FHA – and in my opinion the most important hearing to truly understand FHA's business model.

In our previous hearings, we learned that FHA is nearing insolvency, putting taxpayers at risk of another government bailout. We learned that FHA is operating far outside its historical mission, which is hindering the development of a sustainable housing finance market. And finally, we learned that members on both sides of the aisle strongly support FHA's core mission of providing access to credit for lower-income borrowers and first-time homebuyers.

Today's hearing will explore the business model of mortgage insurance and analyze some of the advantage FHA has relative to private mortgage insurers that compete for the same business.

When we view FHA from a policy perspective, we have to remember that FHA is in the business of insurance. But we will find out today that FHA runs its MMI Fund contrary to the most basic principles of insurance. FHA does not evaluate its risk according to actuarial principles; it does not correlate premiums to risk; it does not spread its risk in a manner supported by its financial resources; and it relies on treating poor results as a quarantined anomaly.

With regard to solvency – which is the cornerstone of insurance regulation – FHA misses the mark by a long shot. FHA's most recent actuarial report showed that its MMI Fund capital reserve ratio, which is a major benchmark for solvency, fell to *negative* 1.44% - well below the Congressional mandated minimum of 2 percent. While private mortgage insurers are instructed to halt all new business once capital reserve ratios fall below 4%, FHA has continued to *expand* business despite being vastly undercapitalized.

FHA shares other advantages relative to its competitors in the private market. On pricing, private insurers use actuarial sound pricing that must include overhead expenses; FHA uses artificially low, uniform pricing that excludes administrative and technological costs. On reserving for losses, private insurers follow 4 different reserve requirements; FHA does not set aside reserves. On accounting, private insurers use GAAP accounting; FHA masks its true financial health with government accounting. And on risk transfer, private insurers oftentimes pay to cede risk to the reinsurance market; FHA has a limitless backstop from the U.S. Treasury.

All of these advantages result in a much lower cost of capital for FHA relative to private insurers. This wouldn't necessarily be a problem if FHA stuck to its historical mission and narrowly targeted its subsidies to lower-income individuals. But, as FHA has attempted to grow out of its past underwriting mistakes, it has expanded its subsidies to large areas of the housing finance market- including high-income borrowers - that do not need government subsidies. Consequently, FHA is directly competing with the private mortgage insurance market on a playing field that is anything but fair.

Not surprisingly, FHA's unwieldy growth has crowded out private capital in the mortgage insurance space and has left private insurers struggling to raise new capital. According to the GAO, FHA's share of the mortgage insurance market, based on volume of loans, stands at 56% compared to just 19% for the private insurers.

There is a proper role for FHA in the housing finance market, but I believe it should be a complement to the private market, not a direct competitor. I look forward to working with Ranking Member Capuano to address these important issues in the months ahead.

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Statement before the
Subcommittee on Housing and Insurance
Of the Committee on Financial Services
United States House of Representatives

On "Mortgage Insurance: Comparing Private Sector and Government-Subsidized Approaches"

Teresa Bryce Bazemore
President
Radian Guaranty, Inc.

March 13, 2013

Introduction

I am Teresa Bryce Bazemore, President of Radian Guaranty, Inc., a leading private mortgage ("MI") insurance company. I am testifying today to discuss the role of private MI in the housing finance system; how private MI differs from government-subsidized mortgage insurance that is provided via the Federal Housing Administration (FHA); and the ways in which housing policies and practices are providing a competitive advantage to federally-insured FHA loans over privately-insured loans. In my testimony, I will also provide several recommendations that policy makers should adopt to return FHA to its historical role; improve the agency's financial condition; reduce the government's role in the housing market; and increase the role of private capital through the use of private MI for the protection of taxpayers.

Private MI is the private sector alternative to loans insured by FHA. Private MI, like FHA, helps qualified low down payment borrowers to obtain an affordable mortgage. Both FHA and private mortgage insurers play an important role in making homeownership affordable and possible for millions of Americans.

FHA has been and remains a valuable part of the housing finance system. However, in the past few years, FHA has dominated the mortgage insurance market due to housing policies and practices that provide competitive advantages to FHA while crowding out private capital in the form of private MI. These actions include increasing Fannie Mae and Freddie Mac ("GSE") guarantee fees ("g-fees") and imposing additional GSE "loan level price adjustments" ("LLPAs"), that make privately-insured loans purchased by the GSEs more expensive than government-backed FHA loans and, therefore, steer borrowers to FHA instead of bringing more private sector capital into the housing market.

Additionally some regulatory proposals, like the proposed risk retention and Basel III rules, would provide FHA with a competitive advantage over private MI, and therefore, would tilt the playing field even further toward FHA loans and government insurance and away from the private sector and private MI.

While FHA has recently taken modest steps to scale back to its historical mission of supporting underserved borrowers, including modestly increasing premiums and strengthening underwriting requirements, policy makers should implement additional reforms, as discussed in this testimony. Ultimately, housing policies should work to scale back FHA to its traditional mission of supporting underserved borrowers, while enabling the private market to be used by borrowers in the conventional market.

The Role of Private MI

The private MI industry was founded in 1957 and since then has helped over 25 million borrowers become homeowners by enabling them to buy homes with small down payments. Today, private MI currently insures more than $700 billion in mortgage loans.

Private MI enables potential homebuyers who cannot make a 20% down payment to purchase their homes. Private MI has played an important role in providing first-time

homebuyers with access to mortgage financing. Private mortgage insurers share this important role with FHA. The most recent National Association of Realtors ("NAR") report on borrower profiles notes that 46% of first-time buyers had FHA financing while 33% obtained conventional financing (with private MI being used by those borrowers who had down payments of less than 20%).

How Private MI Works

When a borrower places less than 20% down to purchase a home, the lender is required to obtain private MI in order for that loan to be eligible to be subsequently sold to the GSEs. The GSEs are the key guarantors of conventional financing today, and private mortgage insurers are the GSEs' key providers of private capital credit enhancement. Lenders are willing to make low down payment loans, and the GSEs are willing to purchase them, because in the event of a homeowner's default on the mortgage, the private MI company pays the owner of the loan a specified amount of the unpaid mortgage.

More specifically, the combination of the private MI coverage and the borrower's down payment will typically cover 25-35% of the loan amount – meaning lenders and investors are at risk for only the remaining 65-75% of the loan amount. For example, if a borrower provides a down payment of 5%, a lender will typically require MI coverage sufficient to cover 30% of the loan amount such that the down payment *combined* with the MI cover approximately 35% of the loan amount, leaving lenders and investors at risk for only 65% of the loan amount.

This practice of requiring private MI in an amount that is 25-35% of the loan reflects the GSEs' prudent determination that this amount of coverage has historically been necessary to cover costs associated with defaulted loans (interest charges during the delinquent period and during foreclosure, legal fees, home maintenance and repair costs, real estate brokers' fees, and closing costs) and any losses resulting from reselling the property for less than the outstanding mortgage loan balance.

Importantly, placing the MI company's private capital at risk in a "first loss" position after the borrower's equity means that both the private mortgage insurer and the borrower have a vested interest in making home loans that are affordable not only at the time of purchase, but also throughout the years of homeownership. Having their own capital at risk also means that private mortgage insurers have very clear incentives to work with lenders, investors, and community groups to help borrowers in default stay in their homes.

How Private MI Uses Private Capital to Protect Taxpayers

Because the GSEs are now in conservatorship, once the loans are purchased by the GSEs, the government is now responsible for losses that result when borrowers default on those loans that are in excess of the amount covered by private MI. In other words, the claims paid by private mortgage insurers are used to reduce losses that would otherwise be paid by the government, and therefore, the taxpayer.

Indeed, over the past four years, private mortgage insurers have paid approximately $34 billion in claims resulting from foreclosure losses to the GSEs that would have otherwise been paid by taxpayers. Moreover, private mortgage insurers are projected to pay approximately $50 billion in total to cover losses from this unprecedented housing downturn.

Underwriting and Pricing for the Risk

Underwriting

In order to be approved for our mortgage insurance, a potential loan is reviewed to determine whether it meets our underwriting criteria. Radian typically performs this function directly or, alternatively, we delegate to our customers – the lenders – the ability to underwrite the loans based on either Radian's underwriting guidelines or, with Radian's prior approval, other agreed-upon guidelines. Radian's underwriting guidelines are prudently established with a view toward ensuring that the borrower has the ability to afford the mortgage at the time of origination and throughout the life of the loan. Loan performance is closely monitored to determine when any changes to guidelines are warranted, including opportunities to expand guidelines.

Through our delegated underwriting program, certain lenders that have been approved by our risk management group are able to approve loans based on our underwriting guidelines. In other words, delegated underwriting allows our customers to commit us to insure loans meeting Radian's approved guidelines. We mitigate the risk of lender underwriting error through quality control sampling and performance monitoring.

Lenders that either do not qualify for or choose not to participate in our delegated underwriting program can submit loan files to us, and we will perform the underwriting. In addition, lenders participating in our delegated underwriting program may choose not to use their delegated authority, and instead may submit loans directly to us. We currently underwrite about one-third of the files, and this direct underwriting also helps inform the quality control process for lenders. We mitigate the risk of employee underwriting error through quality control sampling and performance monitoring.

Pricing

Radian sets its premium rates at the origination of a mortgage loan when coverage is established. Premiums for our mortgage insurance products are established based on performance models that consider a broad range of borrower, loan, and property characteristics. We set our premium levels commensurate with anticipated policy performance assumptions, including our expectations and assumptions about the following factors: (1) the likelihood of default; (2) how long the policy will remain in place; (3) the costs of establishing the policy; (4) taxes; and (5) the capital that is required to support the insurance. Our performance assumptions for claim frequency and policy life are developed based on internally developed data, as well as data generated from independent, third-party sources. The assumptions used in setting our premiums that relate to policy coverage, expenses, and capital are based on data and models that are

developed internally. Premium levels are set to achieve an appropriate, risk-adjusted rate of return on capital given modeled performance expectations.

Private mortgage insurers' premium rates and policy forms are generally subject to regulation in every state in which our insurers are licensed to transact business. These regulations are intended to protect policyholders against the adverse effects of excessive, inadequate, or unfairly discriminatory rates and to encourage competition in the insurance marketplace. In most states where our insurance subsidiaries are licensed, insurance premium rates and policy forms must be filed with the state insurance regulatory authority and, in some states, must be approved, before their use. Changes in premium rates may be subject to actuarial justification, generally on the basis of the insurer's loss experience, expenses, and future projections. In addition, states may consider general default experience in the mortgage insurance industry in assessing the premium rates charged by mortgage insurers.

The Rigorous Reserve and Regulatory Structure of the Private MI Industry

The backbone of the industry's financial strength is its state-imposed reserve, capital, and regulatory requirements.

State-imposed Reserve Requirements

The industry's state-imposed, counter-cyclical capital reserving method ensures that significant reserves are accumulated during good times to enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns.

Private mortgage insurers are required to keep three types of reserves. The reserve requirements were developed in a model private MI act that was established by the National Association of Insurance Commissioners ("NAIC") and is primarily enforced by the states where private mortgage insurers are domiciled.

- Contingency Reserves. The most important reserve is the contingency reserve. Half of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. Therefore, unlike other financial institutions that may pay high dividends during profitable periods, private MI companies build their contingency reserves during these periods in order to have the capital ready to pay the higher claims that inevitably occur during periods of market corrections, such as the one the U.S. is now experiencing.

- Case-basis Loss Reserves. Case-basis loss reserves are established for estimated losses on individual policies when the insurer is notified of defaults and when foreclosures occur. As defaults have increased, the amount of capital put into these reserves has increased substantially in order to ensure that the money is available to pay claims.

- Unearned Premium Reserves. Premiums received for the term of a policy are placed in unearned premium reserves and are earned over time in accordance with state regulation.

The state requirements for private MI are specifically structured to address the long-term nature of the capital at risk for a private mortgage insurer. They enable the private mortgage insurer to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur throughout the normal course of business.

Unlike credit default swaps or other forms of credit enhancement, private MI has already demonstrated its ability to absorb risk. The history of the private MI industry proves that they have paid their claims through good and bad economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated—particularly in energy-oriented regions of the country—defaults began to rise, resulting in numerous foreclosures. The private MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims primarily in California and the Northeast. Policyholders included the GSEs, commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation.

One reason this mortgage boom was so pronounced is that bank regulatory capital requirements permitted speculative growth and then sharply curtailed the ability of lenders to support market recovery. Private MI, on the other hand, is supported by a unique form of counter-cyclical capital that permits mortgage insurers – unlike every other provider of mortgage credit risk mitigation – to meet claims and handle new business even under unprecedented stress. Private mortgage insurers' contingency reserves are directly comparable to the "dynamic provisioning" bank regulators now know they need. Bank regulators are only now working to construct a similar system for banks in the United States and around the world, with Federal Reserve Chairman Ben Bernanke highlighting this as a critical initiative.

Additional State Regulatory Requirements

Private MI companies insure mortgages in all 50 states. Private mortgage insurers operate under monoline licenses issued by state insurance departments that only permit them to write mortgage insurance policies covering the risk of borrower default on residential mortgage loans.

Private mortgage insurers are subject to comprehensive regulation principally designed for the protection of policyholders, rather than for the benefit of investors, by the insurance departments in the various states where our insurance subsidiaries are licensed to transact business. Insurance laws vary from state to state, but generally grant broad supervisory powers to agencies or officials to examine insurance companies and

enforce rules or exercise discretion affecting almost every significant aspect of the insurance business.

State regulators require private mortgage insurers to maintain minimum surplus levels and, in certain states, a minimum amount of statutory capital relative to the level of net risk in force, or "risk-to-capital ratio," typically 25:1, with capital guidelines established by state insurance departments.

State insurance regulation also addresses among other issues, the licensing of companies to transact business, claims handling, reinsurance requirements, premium rates and policy forms offered to customers, financial statements, periodic reporting, permissible investments and adherence to financial standards relating to surplus, dividends and other measures of solvency intended to assure the satisfaction of obligations to policyholders. State regulations also provide for a structure that allows mortgage insurers to continue to pay their claims even if they no longer write new business.

Each insurance subsidiary is required by the insurance regulatory authority of its state of domicile, and the insurance regulatory authority of each other jurisdiction in which it is licensed to transact business, to make various filings with those insurance regulatory authorities and with the NAIC, including quarterly and annual financial statements prepared in accordance with statutory accounting principles. In addition, our insurance subsidiaries are subject to examination by the insurance regulatory authorities of each of the states in which they are licensed to transact business.

Federal Regulatory Requirements

As the largest purchasers of conventional mortgage loans, and therefore, the main beneficiaries of private MI, the GSEs impose requirements on private mortgage insurers that wish to insure loans sold to the GSEs. In order to be eligible to insure loans purchased by the GSEs, private mortgage insurers must meet the GSE eligibility requirements. These eligibility requirements are imposed with respect to the type of risk insured, standards for the geographic and customer diversification of risk, procedures for claims handling, standards for acceptable underwriting practices, master insurance policies, standards for certain reinsurance cessions, loss mitigation, and financial and capital requirements that generally mirror state insurance regulatory requirements. As such, the GSEs and FHFA serve as de facto federal regulators of the private MI industry.

Additionally, private MI companies are subject to requirements under various federal laws, including anti-referral fee provisions under the *Real Estate Settlement Practices Act of 1974,* licensing and registration provisions under the *SAFE Mortgage Licensing Act*, loan data disclosure requirements under the *Home Mortgage Disclosure Act of 1975*, and coverage cancellation and termination requirements under the *Homeowners Protection Act of 1998.*

Comparison of Private MI vs. FHA

While private MI and FHA are similar in that they enable borrowers to buy homes with less than a 20% down payment by paying lenders and investors if a home goes into foreclosure, there are some significant differences in the way that the two models are structured. As Congress considers ways to improve FHA's financial health, it should consider some of the attributes of the private MI model that have proven to be successful.

- **Coverage**. FHA insures 100% of the loan amount if the home goes into foreclosure so that the loan originator lacks any meaningful risk of loss. Currently, taxpayers are on the hook for the over $1 trillion in mortgages that FHA is insuring. Private MI, on the other hand, places private capital in a first loss position behind the borrower's equity and generally represents 25% to 35% of the loan amount, which covers most, but not all, of the losses that the parties to the mortgage transaction experience so there remains an incentive to avoid foreclosure. Notably, the federal VA mortgage program provides limited coverage of 25% to 50% for the loans insured under its program, and the success of the VA program demonstrates that this lower level of coverage results in better underwriting and loan performance, which reduces both probability of default and severity of loss.

- **Capitalization – Leverage Ratios.** The most recent actuarial report for the FHA Mutual Mortgage Insurance ("MMI") fund (excluding reverse mortgages) shows total capital resources of $25.6 billion dollars offsetting over $1.1 trillion dollars of insurance in force, which for FHA is its risk in force because FHA insures 100% of the loan amount so that its risk is not capped. However, once the projected losses on FHA's existing books of business are added to the calculation, these losses wipe away all of the FHA resources resulting in a negative economic value to the fund of $13.5 billion. By comparison, private mortgage insurers are generally required to have a risk-to-capital ratio of 25:1.

- **Underwriting.** FHA has a "one size fits all" type of underwriting system, which does not allow FHA to respond to the build–up or deflation of mortgage market bubbles. Private mortgage insurers, on the other hand, have heavily invested in analytical tools so that we can make sure the loans we insure meet our independent requirements. Private mortgage insurers are constantly monitoring the regional mortgage markets and altering their underwriting to ensure that the home is affordable for the borrower at closing and over the life of the mortgage.

- **Borrower profiles.** Private MI borrowers tend to have slightly higher incomes than typical FHA borrowers and higher FICO scores. The different borrower profiles are consistent with the different missions of the two models. Private MI was designed for first-time and low- to moderate- income borrowers who, but for the 20% down payment requirement, would otherwise be able to access financing through the conventional market. On the other hand, FHA was designed to make

homeownership an option for borrowers who were unable to be served by the conventional market.

- **The Guarantee.** Ginnie Mae charges 6 basis points on all FHA or VA loans to lenders (and ultimately borrowers) to provide government guaranteed "catastrophic loss" protection to investors in Ginnie Mae securities. The GSEs provide the same protection on conventional loans, but also frequently take on more of the risk resulting in much larger guarantee fee costs to the borrower. Further, privately-insured GSE loans are backed by private capital, while FHA-insured Ginnie Mae loans are fully guaranteed by the government. As a result, GSE g-fees are typically in excess of 20 basis points on privately-insured conventional loans. The difference in cost to the consumer is a material factor in lenders favoring FHA loans.

- **Lender Enforcement.** In cases of loan default, fraud, and/or misrepresentation, FHA may simply require a lender to "indemnify" FHA against losses on the loan. However, if the same conditions are found on a conventional loan, the GSEs may require a lender to repurchase the loan (with interest). That repurchase requirement on conventional GSE loans is far more cumbersome and costly to lenders and translates to higher borrower costs as well.

- **Analytics.** Over the last several years the Department of Housing and Urban Development Inspector General and the General Accountability Office have enumerated various problems with FHA's automated underwriting systems and other operating systems. Because private capital is at risk, private mortgage insurers have the ability to receive up-to-date information on their portfolios and to use external data sources to do timely comparative analyses of their portfolios. This enables them to better understand trends in the market and set better criteria.

A Brief History of the Mortgage Crisis as it Affected Private Mortgage Insurers and FHA

As the housing bubble grew from 2000 to 2007, both FHA and private mortgage insurers found themselves at a disadvantage. Their efforts to promote responsible underwriting of mortgages for first-time homebuyers was undermined by the development of mortgage products the purpose of which was to avoid the use of ANY type of mortgage insurance – whether FHA insurance or private MI.

These mortgage products took several forms including piggyback loans where the borrower was given two mortgages (a first mortgage and a contemporaneous second mortgage) to cover the acquisition of a house with effectively zero cash down payment or even a negative down payment. The often advertised purpose of these loans was to avoid the payment of mortgage insurance by the borrower and—less advertised but just as important—to avoid the review of the borrower's ability to pay the mortgage(s) that was and is inherent in the use of government or private mortgage insurance. In addition, private MI premiums were not yet tax deductible at that time while the higher interest paid on the second mortgage was tax deductible.

At the height of the boom, the new products that were developed were based on an assumption that house prices could only rise and consequently that, even if the borrower could no longer afford the mortgage, the worst that would happen would be that they would sell the house and the mortgage investor would be repaid in full at no cost to the entity securitizing the mortgage or to the taxpayer.

Both private MI companies and FHA were challenged by the expansion of these products. Indeed, at the height of the mortgage bubble, both FHA and Ginnie Mae expressed concern that the volume of new FHA loan originations was insufficient to maintain the liquidity of the Ginnie Mae market.

In order to remain in the market, the underwriting standards and pricing by both FHA and private mortgage insurers weakened. This weakening took the form of lower insurance premiums by both FHA and private mortgage insurers in an effort to compete against the uninsured high loan-to-value ("LTV") mortgage products. The weakening also involved greater acceptance by private mortgage insurers of the lenders' underwriting decisions of low or no documentation loans and the decisions generated through the automated underwriting systems employed by Fannie Mae and Freddie Mac. For FHA, the relaxed underwriting included the acceptance of seller paid down payment contributions, as well as other underwriting changes.

As house prices began to fall, certain participants in the mortgage market were made aware of problems sooner than others. Lenders holding mortgages on their books saw the increase in delinquencies first and responded by tightening their proprietary underwriting requirements. To continue volume, however, many originated loans regardless of possible risk if these qualified for FHA or private MI. The GSEs and private mortgage insurers became aware of the higher rate of delinquencies later than the lenders and then tightened their underwriting standards and raised their premiums, but during the period when lenders shrank their piggy-back loan originations and other risky loan originations, private mortgage insurers were adversely selected. This "adverse selection" problem is among those proposed for regulatory reform in a recent paper on ways to improve both public and private mortgage insurance that was released earlier this year by the Joint Forum.

Beginning in 2007 and 2008, FHA saw a flood of new mortgage originations enter its books as lenders, the GSEs, and private mortgage insurers tightened their own underwriting requirements and raised their premiums and delivery fees to respond to market conditions. At the time this occurred, FHA had the lowest upfront insurance premium in its post-1990 reform history, and its annual premiums were set at a legislative minimum level. As a consequence, loans that otherwise would have gone to the subprime market or to the expanded approval, Alt-A, and other programs initiated by the GSEs instead were steered by lenders to FHA. This adverse selection of FHA – a consequence of inadequate FHA premiums, delegated FHA underwriting to lenders without adequate oversight, and the difficulty of a government program to quickly respond to a changing mortgage market—resulted in FHA holding on its books a large share of subprime-like mortgages that were inadequately priced and poorly originated.

Private Mortgage Insurers and the Housing Downturn

The private MI share of the mortgage market contracted significantly as the crisis unfolded in 2008-2010. The entire industry faced higher claims requests as house prices fell and borrowers defaulted on their loans. Some private mortgage insurers stopped insuring new mortgages due to capital limitations. Like most financial institutions, private mortgage insurers were stressed by the significant nationwide house price collapse. But during this period of unprecedented stress to the private MI industry, private mortgage insurers continued to pay legitimate claims. From 2007 through the third quarter of 2012, the private MI industry had paid over $30 billion in cash claim payments and $3.6 billion in claim receivables to Fannie Mae and Freddie Mac alone as verified in their SEC filings.

Another factor contributing to the declining market share of privately insured mortgages in this time period were actions by Fannie Mae and Freddie Mac that made the loans that they purchased more expensive. After the GSEs entered conservatorship in the fall of 2008, they increased the fees they charged to purchase the high LTV loans of borrowers with moderate credit scores. The combination of higher GSE delivery fees, tighter GSE and private MI underwriting, and higher private MI premiums caused the private MI share of the insured low down payment mortgage market to shrink significantly. Those actions by the GSEs, combined with higher FHA loan limits beginning in 2008, resulted in the private MI share of the insured low down payment mortgage market that is served by FHA and private MI combined contracting from 77% in 2007 to 16% in 2010.[1]

FHA and the Housing Downturn

The delegated underwriting concept underlying the operations of FHA, combined with the 100% insurance coverage applicable to all FHA-insured loans, resulted in a lack of information flowing to FHA as to the weakness in the market in general and the need to tighten its underwriting and appraisal requirements in particular.

FHA did not begin to recognize the negative impact of declining house prices until 2010. It was only then that FHA chose to begin tightening its underwriting and raise its premiums with increases in the annual premiums occurring in October 2010 in response to additional authority given to it by Congress that year. By 2010, FHA's market share of the insured market had increased from 17% in 2007 to 68%. By the time the FY 2012 actuarial report was issued by HUD, the loans that had been originated in 2007 through 2010 without tightened underwriting or higher premiums accounted for 51% of FHA's total insurance in force.

FHA has taken several steps to tighten its underwriting and raise its premiums in subsequent years. Whether these steps will be sufficient to offset the negative financial

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[1] The remaining portion of the low down payment market is insured by other entities such as the U.S Department of Veterans Affairs ("VA") and the U.S. Department of Agriculture.

impact of FHA's rapid growth during a period of collapsing house prices has yet to be determined.

What is clear, however, is that FHA as a government program provided access to credit for many low down payment borrowers as the housing crash unfolded. This is the role that a government program should play during a period of economic contraction. Unfortunately, the structure of FHA as a 100% insured government program that has delegated its underwriting to lenders has resulted in significant losses to the program.

Private MI: Going Forward

Private mortgage insurers have the capacity to insure the current and projected volume of low down payment loans. Despite having paid over $34 billion in claims since the crisis began, private MI companies have also continued to write new insurance throughout the crisis. Although capital limitations at a few of the companies has meant that those companies are unable to write new business, the other private MI companies – including Radian – have increased the amount of loans they are insuring. In fact, the private MI industry has been gradually increasing its market share in recent years. In 2012, the private MI share of the insured low down payment market increased from 26% in the first quarter to 35% in the fourth quarter.

The industry has attracted over $7 billion in new capital throughout the mortgage crisis, two new entrants to the private MI industry have together brought more than $1 billion in new capital, and a third company—just announced last month—will be part of a well capitalized and well established multi-billion dollar reinsurance company. Similarly, private MI companies with legacy books of business have taken steps both to raise capital and to reinsure their business in order to effectively bolster their capital position. Over the last two weeks, Radian and MGIC have raised almost $1.8 billion in private capital.

Looking ahead, private mortgage insurers stand ready to play a critical role in the future of housing finance by continuing to safely and soundly enable first-time and lower income families to obtain affordable mortgage loans while protecting taxpayers from the losses that result from borrower default.

Current Housing Policies and Practices Provide FHA with a Competitive Advantage over Private MI

As noted several times throughout this testimony, both FHA and private mortgage insurers have important roles to play in promoting a vibrant and sustainable housing market. Appropriately, however, there is concern that the mortgage market is substantially controlled by FHA and the GSEs, with FHA today insuring approximately 56.4 percent of all insured mortgages. Meanwhile, private mortgage insurers only represent roughly 35% of the market. This is because, in the past few years, FHA has dominated the mortgage insurance market due to housing policies and practices that provide competitive advantages to FHA while crowding out private capital in the form of private MI.

Many of the policies and practices described below steer borrowers to FHA either by making privately-insured loans purchased by the GSEs more expensive than government-backed FHA loans or providing lenders with other incentives to encourage borrowers to obtain FHA-insurance over private MI.

- **FHA Loan Limits.** Beginning in 2008, Congress temporarily increased the FHA loan limits in both high-cost and non-high-cost areas. These limits expired as scheduled in October 2011. However, in November 2011, Congress reinstated the increased limits for both high cost and non-high-cost areas. This action restored FHA's higher loan limits without commensurately restoring the GSEs' higher loan limits, thus making loan limits for government-insured loans higher than loan limits for privately-insured loans for the first time in history. This unprecedented move permits FHA to service segments of the market that are now closed off to private mortgage insurers, thereby driving business to the FHA and away from the private MI industry.

- **FHA Premiums.** FHA currently underprices the risk that it insures. FHA premiums do not reflect the true risk of the loans that FHA insures as reflected by comparable private MI premium pricing.

- **FHA Federal Guarantee.** FHA insures 100% of the loan amount if the home goes into foreclosure so that the loan originator lacks any meaningful risk of loss. Private MI, on the other hand, stands in a first loss position behind the borrower's equity and generally is 25% to 35% of the loan amount.

- **GSE G-fees.** G-fees are additional fees charged for mortgages that are purchased and guaranteed by the GSEs. In December 2011, Congress included a 10 basis points g-fee increase as a "pay-for" in a two-month payroll tax cut extension. In August 2012, the FHFA directed the GSEs to increase their g-fees again by 10 basis points, effective November 2012. This legislation increased the GSE g-fee to 35 basis points as compared to the 6 basis points guarantee fee that is applied to loans that are insured by FHA and guaranteed by Ginnie Mae. The effect of increasing GSE g-fees is to make privately-insured loans purchased by the GSEs more expensive to originate and sell, thereby driving borrowers to FHA.

- **GSE Loan Level Price Adjustments**. Over the past couple of years, the GSEs have imposed so-called "loan level price adjustments" ("LLPAs") on existing, high-performing loans in an attempt to cover losses from the low-performing books that the GSEs serviced prior to 2008. The GSEs claim that these LLPAs are risk-based, but in fact, they are arbitrarily imposed fees that are designed to increase revenue. Fannie Mae and Freddie Mac continue to increase the fees that they charge to borrowers, including both g-fees and LLPAs, beyond what is actuarially sound, thereby steering borrowers away from privately-insured loans that are purchased by Fannie Mae and Freddie Mac toward fully government-backed FHA-insured loans.

- **FHA Indemnification Enforcement.** The HUD Secretary has the authority to require lenders to indemnify the Secretary for the loss incurred when HUD pays a claim on a loan insured by FHA if the loan was not originated according to HUD's established guidelines or if fraud or misrepresentation was involved in the loan's origination. In practice, however, HUD has not actively or broadly exercised its enforcement authority in this area. As a result, lenders, when helping a borrower to choose between an FHA-insured loan or a privately-insured loan, take into consideration the reality that HUD is unlikely to require the lender to indemnify HUD in the event of borrower default, even if the loan was not originated in accordance with HUD's guidelines. On the other hand, in the event of improper origination, the GSEs may require the lender to repurchase the loan. Thus, HUD's indemnification enforcement practices provide an incentive for lenders to steer borrowers to FHA loans.

- **"Qualified Residential Mortgage" Definition.** In the proposed "qualified residential mortgage" rule ("QRM"), loans with 20% down payments and low down payment loans insured by FHA are both exempt from the Dodd-Frank risk retention requirements. Loans guaranteed by the GSEs are also exempt from the risk retention requirements while the GSEs are in conservatorship. Low down payment loans that are privately insured are not included in the QRM exemption. This means that, after the GSEs' conservatorship ends, the only low down payment loans that would be exempt from the risk retention requirements would be those insured by FHA. This would increase FHA's market share while decreasing the private MI industry's ability to compete, despite the fact that the Congress has made clear to the regulators that they should define the QRM to include low down payment loans that are insured by private MI. This could also be accomplished by synchronizing the QRM definition with Qualified Mortgage definition under Dodd-Frank, thereby eliminating any additional down payment requirement.

- **Basel III.** The U.S. banking regulators have proposed rules to implement Basel III in the United States. The proposed rule would significantly raise minimum capital requirements for banks and, for residential mortgages, the proposed rule would assign risk-weightings based on LTV. FHA loans retain a risk weighting of zero. However, the banking regulators do not recognize private MI as a risk mitigant when assigning residential mortgage credit asset risk-weightings based on a mortgage's LTV ratio. This means that, as proposed, a loan with a 5% down payment that <u>is</u> insured by private MI would be treated the same as a loan with a 95% LTV <u>without</u> private MI in terms of the amount of capital that a bank must hold for that loan. Therefore, the proposed rule would favor high down payment loans by making low down payment loans more costly and also further tilt the playing field for low down payment loans to FHA.

Recommendations for the Future

Reforms are necessary to scale back FHA to its stated historical mission of supporting underserved borrowers and to improve the agency's financial position while enabling private MI, with its reliance on private capital, to be used by borrowers in the conventional market. I provide several recommendations below:

Share the risk with the private sector. Changes are needed both to protect the FHA and the U.S. taxpayer and, just as importantly, to protect future FHA borrowers who should not be put into homes they cannot afford to keep. FHA should be authorized to enter into a modern risk-share agreement with private mortgage insurers. Under this risk-share, the private mortgage insurer will conduct an independent underwriting of the FHA borrower and the mortgage being sought. If the borrower and the mortgage underwriting terms meet the conditions mutually agreed upon between FHA and the private mortgage insurer, then the private mortgage insurer will take the first loss on the FHA loan with the deeper loss covered by FHA. In this way, FHA and the U.S. taxpayer will be protected by an independent underwriting at the front end of the loan origination and private capital will be placed at a position of first loss risk on any future claim arising from the mutually insured loan. In this way, the potential FHA borrower also will be protected by the upfront private MI underwriting from entering into a mortgage that places him or her at risk of foreclosure.

Focus FHA on low and moderate income borrowers. FHA's loan limits have been set at very high levels, which make the program attractive to borrowers with comparatively high incomes. In high cost areas, FHA insures mortgages up to $729,750. Even at interest rates as low as 3.5%, a borrower needs an annual income of no less than $175,000 to qualify for a loan of this size. Nationwide, the FHA has a base loan limit of $271,050, which is now almost $100,000 higher than the average existing home sold in 2012 according to NAR.

Additionally, the concept of a government program targeted to house prices and loan amounts, rather than the income of the borrower, no longer makes sense. What we have seen over the years is that the FHA loan amounts continue to increase while the average American's income stagnates. Even when house prices fall in an area, the FHA loan limits remain frozen. Thus, through FHA, the U.S. taxpayer is being asked to subsidize larger and larger mortgages for those people who can afford them without taxpayer assistance.

In this time of budgetary struggles, asking taxpayers to subsidize higher income and wealthy borrowers through government mortgage insurance seems like curious public policy. Rather, the FHA program should be targeted to the median income of the household in an area. In fact, the Administration's February 2011 white paper to Congress on housing finance reform specifically called for limiting FHA eligibility to borrowers that have incomes below the median level for their area. In this way, FHA will be targeted to serve only the moderate and middle-income borrowers who need their help. FHA should not be used by higher income borrowers who can afford the highest priced

homes in an area even where the average family in that same area could not dream of affording the same high-priced home.

Reduce the level of the government guarantee. Congress should also reduce the FHA's guarantee below its current 100% level – similar to the VA mortgage program. An essential feature of private MI is the concept of coinsurance on the part of all parties to the transaction. Private MI stands in a first loss position behind the borrower's equity and generally is 25% to 35% of the loan amount, which covers most, but not all, of the losses that the parties to the mortgage transaction experience so there remains an incentive for all parties to avoid foreclosure. FHA, on the other hand, insures 100% of the loan amount if the home goes into foreclosure so that the loan originator lacks any meaningful risk of loss. This 100% guarantee does not properly align incentives between originators and the FHA. Reducing the 100% coverage amount will provide lenders with an incentive to conduct prudent underwriting. It will also reduce taxpayer exposure to losses resulting from borrower default, and this will reduce the budgetary cost of FHA's program.

Provide more flexibility for FHA premiums. One major reason FHA is in such financial distress is that it historically did not charge premiums that were appropriate for the risk. In order to adequately protect the FHA fund and the taxpayer and to avoid an unfair government price advantage compared to the private sector, Congress should provide FHA with additional authority to adjust its premiums to levels that reflect the true risk of the loans that it insures. Doing so will help FHA to prevent a costly taxpayer bailout.

Avoid government actions that unintentionally drive borrowers to FHA. It is important that the government not take actions that unfairly tilt the playing field to government insured programs like FHA rather than private MI, thereby discouraging reliance on private capital in the housing market. As policy makers scale back the GSEs, they have also reduced opportunities for private MI, which means that low down payment loans will be insured by the FHA. For example, Fannie Mae and Freddie Mac, at the behest of Congress and the Federal Housing Finance Agency, continue to increase the fees that they charge to borrowers, such as GSE guarantee fees and LLPAs beyond what is actuarially sound, thereby making privately-insured loans purchased by the GSEs more expensive than FHA-insured loans. As a result, increasing GSE pricing steers borrowers with low down payments away from privately-insured loans that are sold to Fannie Mae and Freddie Mac and towards government-backed FHA-insured loans. Policy makers should discontinue the practice of increasing GSE g-fees and LLPAs unless there is demonstrated additional risk and GAO should publish and submit to Congress an annual, independent, actuarial review of GSE pricing.

Regulations that Could Potentially Advantage FHA

QRM. As discussed previously, regulators are today considering the appropriate mortgages to include within the QRM exemption to the Dodd-Frank risk retention requirements. The proposed rule would limit the QRM exemption to loans with 20% down payments. Additionally, regulators have proposed to automatically exempt FHA-

insured loans from the risk retention requirements, and loans guaranteed by the GSEs are also exempt from the risk retention requirements while the GSEs are in conservatorship. Low down payment loans that are privately insured are not included in the QRM exemption. This means that, after the GSEs' conservatorship ends, the only low down payment loans that would be exempt from the risk retention requirements would be those insured by FHA.

As proposed, the rule would increase FHA's market share while decreasing the private MI industry's ability to compete, significantly and unnecessarily impeding the availability of private capital to serve low down payment borrowers. Ultimately, the U.S. taxpayer will be asked to bear even more of the risk associated with low down payment borrowers.

Synchronizing the QRM definition with Qualified Mortgage definition under Dodd-Frank would eliminate any additional down payment requirement. There is much support for this outcome. With the elimination of risky mortgage terms through the final Qualified Mortgage rule, the low down payment borrower is protected from entering into a risky mortgage.

However, if a down payment requirement is included in the QRM exemption, then the QRM exemption should include loans with down payments of 5% to 20% provided that they have first loss loan level insurance coverage by an adequately capitalized private mortgage insurer. The presence of private MI ensures that the private sector has "skin in the game," thereby achieving the primary goal of the risk retention requirements. Additionally, a 5% down payment loan insured by private MI has historically provided more protection to lenders and investors from the risk of default than would a 20% down payment. This is because when adequate private MI coverage is required on a low down payment mortgage, the combination of the private MI coverage and the borrower's down payment will typically cover 25-35% of the loan amount – meaning lenders and investors are at risk for only the remaining 65-75% of the loan amount instead of 80% for a loan with 20% down without private MI.

Basel III. Currently, the U.S. risk-based capital rules (generally referred to as Basel I when they apply to community banks and Basel II when applicable to the largest banks) provide a zero risk weight for obligations backed by the full faith and credit of the United States Government ("USG"), including mortgages insured by FHA or mortgage backed securities guaranteed by Ginnie Mae comprised of FHA-insured loans. The Basel I rules also have allowed the U.S. banking agencies to provide a reduced risk weight for high LTV mortgages when these are backed by private MI. This means that loans with LTVs that are greater than 80% carry a 100% risk weight, while those loans with LTVs that are greater than 80% and insured by private MI have a 50% risk weight. For Basel II banks, the internal models that determine risk weightings also may take private MI into account to reduce risk weightings for all insured loans.

The proposed Basel III rules that would govern all U.S. insured depositories and their holding companies maintain the zero risk weighting for USG-backed obligations. This means that the banks could still hold no risk-based capital related to FHA-insured

loans. However, the proposal would eliminate any reduced risk weighting when private MI is used, thus making it equally costly under the capital rules to hold a high LTV mortgage with or without private MI.. For example, as proposed, a loan with 5% down that is insured by private MI would be treated the same as a loan with a 95% LTV without private MI in terms of the amount of capital that a bank must hold for that loan.

The practical effect of this proposed treatment is two-fold. First, it creates a strong regulatory incentive for U.S. banking organizations to hold only USG-backed mortgage obligations, significantly increasing taxpayer risk. Secondly, it makes high LTV mortgages that are privately insured unnecessarily costly for lenders because the value of private MI as a proven form of credit risk mitigation is not reflected in the applicable risk-based capital requirement. Given the need for high LTV mortgages to be insured outside of FHA, the proposed Basel III rule will sharply reduce credit availability to borrowers like first-time homeowners. Instead, the final rule should continue the current treatment of private MI and permit banks to offset some of their capital with that of qualified private mortgage insurers, as this will significantly increase credit availability for first-time homebuyers without putting either the bank or taxpayer at risk.

Conclusion

FHA has served and should continue to serve a critical role in the housing finance system by providing access to homeownership to those low and moderate income borrowers who are unable to obtain loans via the conventional market. However, the recent crisis has identified issues that should be addressed in order for FHA to continue to play this important role. For example, in the report it released last month, the Bipartisan Policy Center recommended that Congress lower FHA loan limits and increase FHA premiums to return FHA to its traditional role.

Indeed, FHA reform should be undertaken with a view toward reducing the role of the federal government in the mortgage market, increasing the role of private sector capital, and preventing future taxpayer bailouts. This necessarily includes scaling back FHA to its traditional role of supporting underserved borrowers and discontinuing housing policies and practices that provide a competitive advantage to FHA over private MI.

In examining the range of reforms before the Subcommittee, I urge you to:

- Authorize risk-sharing between private mortgage insurers and FHA. This will introduce private-sector discipline to FHA underwriting and place private capital in a first loss position ahead of the taxpayer;

- Alter FHA-borrower eligibility standards to target them to low- to moderate-income levels, not house prices. This will allocate taxpayer resources to serve the FHA's rightful mission;

- Consider additional reforms, including reducing the FHA's guarantee below its current 100% level, much the same as the VA mortgage program. This will properly align incentives between originators and the FHA;

- Require FHA to establish premiums that accurately reflect the true risk of the loans that it insures. This will help to ensure that FHA avoids a costly taxpayer bailout;

- Avoid government actions, such as GSE price increases, that steer borrowers with low down payments away from privately-insured loans purchased by the GSEs and toward federally-insured FHA loans. This will bring more private capital into the housing market;

- Encourage regulators to exclude prudently underwritten, privately-insured loans from the Dodd-Frank risk retention requirements; and

- Encourage regulators to continue the current treatment of private MI in the final Basel III rule and permit banks to offset some of their capital with that of a qualified private mortgage insurers.

Milliman

TESTIMONY

Mortgage Insurance:
Comparing Private Sector and Government-Subsidized Approaches

Before The

The Subcommittee on Housing and Insurance
United States House of Representatives

Wednesday, March 13, 2013 at 10:00 a.m.
Room 2128 Rayburn House Office Building

Prepared by:
Milliman, Inc.

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March 12, 2013

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TESTIMONY

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OPENING REMARKS

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee: Thank you for the privilege of appearing before you today.

My name is Ken Bjurstrom. I am a Principal at Milliman, Inc., where my practice focuses on mortgage credit risk analysis for the mortgage insurance and mortgage banking industry. In association with Milliman, I have conducted analyses of the private mortgage insurance industry at the request of individual companies and their trade association. At the request of the U.S. Department of Housing and Urban Development's Inspector General, I have conducted several reviews of the actuarial report for the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (MMIF).

You have asked me to discuss and compare the mechanics of the private mortgage insurance business and the FHA, including its operational, structural and regulatory components and include any other legislative and regulatory suggestions that I believe will enhance FHA, protect taxpayers and facilitate the return of private capital. To that end, in my testimony I will recommend that the FHA evaluate and adopt many of the private mortgage insurance statutory accounting provisions, better understand and modify their exposures to those that specifically support their mission and retain the necessary capital that is required to protect the Mutual Mortgage Insurance Fund currently and for the next economic downturn that will most definitely occur again, at some point in the future.

MORTGAGE INSURANCE

Mortgage insurance makes home ownership possible for first time home-buyers with limited credit history and underserved borrowers with limited resources. Without such insurance coverage, mortgage lenders would generally require a borrower to have a downpayment equal to at least 20% of the home's value. With mortgage insurance coverage, mortgage lenders are able to originate loans to borrowers with downpayments of as little as 3%.

To the extent that the losses associated with mortgage defaults tend to vary based on macroeconomic conditions, a mortgage insurer, whether it is a private mortgage insurer or the FHA, is in the business of "insuring the economy." During periods of economic expansion, the credit environment is generally healthy and mortgage default losses tend to moderate or diminish, enabling insurers to realize and retain underwriting earnings to cover potential losses that inevitably arise in the economic contractions that follow. During recessions, the credit environment deteriorates and default-related losses tend to mount, potentially causing mortgage insurers to draw down their stockpiles of retained underwriting earnings to cover claims.

Exhibit 1 illustrates the annual rate of change in the FHFA All Transactions historical and forecasted home price Index and unemployment rate developed by Moody's Analytics as of September 30, 2012. During the early 1980s and again in the early 1990's, as well as over the last few years, the economy has suffered declines in home prices or increases in unemployment resulting in mortgage insurance claims. Subsequent to each of these periods of economic stress the FHA's MMIF experienced substantial losses.

Exhibit 2 illustrates the actual and ultimate forecasted claim rates by endorsement year of the MMIF according to the most recent FHA actuarial review[1]. Both the actual and forecasted claim rates in this exhibit were produced by the FHA's independent actuary. For endorsement year 1981, roughly 22 out of every 100 FHA borrowers defaulted and lost their home resulting in a mortgage insurance claim to the FHA. For endorsement years 1990 through 2003, approximately 8 out of 100 FHA borrowers resulted in a claim to the FHA. For 2007 endorsements, over 30 out of every 100 FHA borrowers are estimated to result in an FHA claim demonstrating the volatility of the mortgage insurance business.

[1] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012, November 5, 2012, Integrated Financial Engineering.

MORTGAGE INSURANCE OPERATIONS

As Illustrated, this unique line of insurance exposes mortgage insurers like the FHA to considerable risks. The non-cancelable contracts for extended durations of coverage coupled with the economically correlated individual risks lead to extreme volatility of losses. This, in turn, necessitates mortgage insurers such as the FHA to maintain basic disciplines that govern the financial operations including underwriting and ratemaking, loss reserving and high capital commitments as directed by counter parties, regulators and rating agency requirements.

Underwriting and Rate Making

According to the Statement of Principles Regarding Property and Casualty Ratemaking (SOP-Ratemaking) as adopted by the Board of Directors of the Casualty Actuarial Society (CAS), Ratemaking is defined as "the process of establishing rates used in insurance or other risk transfer mechanisms."

The following four ratemaking principles are specified in SOP-Ratemaking and can be applied to mortgage insurance ratemaking:

- Principle 1: a rate is an estimate of the expected value of future costs;
- Principle 2: a rate provides for all costs associated with the transfer of risk;
- Principle 3: a rate provides for the costs associated with an individual risk transfer;
- Principle 4: a rate is reasonable and not excessive, inadequate or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

The key objective of the ratemaking process is therefore the estimation of the costs associated with the transfer of risk effected by issuing mortgage insurance policies. Historically, mortgage insurers have generally used the size of the down payment or loan-to-value, product type such as fixed rate or adjustable rate and the amount of coverage in their underwriting and rate making approach. Relatively recently, private mortgage insurers have expanded their premium rate programs to recognize the importance of borrower FICO Scores and other factors.

In contrast, the FHA currently utilizes fewer tools available to them to financially manage mortgage insurance exposures. The FHA insures 100% of the potential claim loss, compared to generally 25% to 35% for private mortgage insurers, and the FHA charges the same premium rates for all loan product types and borrower FICO Scores. Without a more granular approach to ratemaking the FHA may be encouraging adverse selection with respect to obtaining FHA mortgage insurance protection.

Ratemaking for mortgage insurance should take these factors into account and take a long-term view of pricing while also considering the important roles of adverse selection and changes in the underlying insured risks. The adverse selection effects of alternatives to mortgage insurance coupled with the potential for future boom and busts in the housing market add to the operational challenges of mortgage insurance industry.

Statutory Reserve Requirements

Mortgage insurance losses represent the costs of claims arising from defaulting loans insured under mortgage insurance policies. Such losses are incurred when a loan becomes delinquent and ultimately gives rise to a claim by an insured lender or investor. A private mortgage insurer must be licensed in each state where it writes business and insurance laws generally require private mortgage insurers to adequately maintain the following reserves:

- Unearned Premium Reserve:
  - ✓ A reserve on an annual or on a monthly pro rata basis on all unexpired coverage, except that in the case of premiums paid more than one year in advance, the premium shall be earned proportionally with the expiration of exposure;
- Loss Reserve (both a case and incurred but not reported reserves) and Loss Adjustment Reserves:
  - ✓ Case basis loss reserves are based on an estimate of the liability for claims on individual insured loans in various stages of default;
  - ✓ An incurred but not reported reserve is based on an estimate of the liability for future claims on insured loans that are in default but of which the insurer has yet to be notified by the servicer; and
  - ✓ A loss adjustment expense reserve is based on an estimate of the cost of adjusting and settling claims on insured loans in default;
- Contingency Reserve:
  - ✓ A reserve, which consists of fifty percent (50%) of the insurers earned premium and is maintained for ten years. Subject to the approval of the commissioner, withdrawals may be made from the contingency reserve in any year in which the actual incurred losses exceed 35% of the earned premiums.

Additionally, general insurance requirements may also require a premium deficiency reserve. A statutory premium deficiency exists if future paid losses and expenses on unexpired business as of an evaluation date exceed the related premium revenue for such business (on a present value basis), along with the current loss reserves, unearned premium reserve and contingency reserve.

The reserve requirements for private mortgage insurance require the company to account for near-tem expected losses, restrict shorter-term dividends and measure the company's ability to write new business. The FHA in contrast does not have a comparable reserving methodology.

Statutory and Industry Capital Commitment

Private mortgage insurers are generally subject to a maximum risk-to-capital ratio of 25:1 (i.e., the ratio of insured loan risk exposure [coverage times original loan balance] to the sum of policyholders' surplus and contingency reserves). Taken together, the contingency reserve and risk-to-capital ratio requirements have the effect of requiring the private mortgage insurer to build reserves and surplus during periods of economic growth and stability so that they are in position to cover substantial levels of claims during periods of economic downturn.

In addition, Fannie Mae and Freddie Mac (the GSEs) have developed a rigorous set of eligibility requirements for their approved private mortgage insurers. Private mortgage insurers must comply with these requirements in order to maintain approval to insure mortgage loan business purchased or securitized by the GSEs. The requirements have been periodically updated over time as the mortgage lending environment has evolved and the GSEs' needs have changed.

The three major credit rating agencies also monitor the financial safety and soundness of the mortgage insurers. In part, the agencies have assumed this role in conjunction with GSE private mortgage insurer eligibility requirements.

The FHA MMIF is not subject to the statutory reserve requirements or comparable capital requirements as those that apply to private mortgage insurers.

The 1990 Cranston-Gonzalez National Affordable Housing Act requires an independent actuarial analysis of the economic net worth and financial soundness of the FHA MMIF. The primary purpose of this actuarial review is to estimate (excluding Home Equity Conversion Mortgages):

- The economic value of the MMIF, defined as the sum of existing capital resources, total assets less total liabilities of the MMIF, plus the net present value of the current books of business; and
- The total insurance-in-force (IIF) of the MMIF.

The FHA is required to maintain a 2 percent ratio of the economic value of the MMIF to IIF (capital ratio). This ratio requirement and the economic valuation from which it is derived is the FHA's only gauge of its ability to withstand losses

The economic value calculation for the FHA has several inherent weaknesses. The calculation is based on a 30-year time horizon and is subject to a forecast of the United Sates economy. Exhibit 1 attached to my testimony highlights the actual and forecasted rates of home prices and unemployment since 1979 and the assumptions currently used by the FHA in assessing its actuarial soundness. Although the current financial crisis is generally reflected beginning in 2007 and recovering in 2013, the longer-term forecasts generally assume a return to a 6% unemployment rate and home prices appreciating at greater than 3%. This long-term forecast results in significant positive economic value for the most recent endorsement years as if these economic forecasts were certain. Because the more recent endorsement years have the potential for significant variability over the long-term the calculation should consider the risk associated with economic outcomes and insurance liabilities, particularly given the size of the more recent endorsement years. In contrast, the private mortgage insurers do not take credit for the economic value reflected in future premiums in terms of their statutory capital requirements.

If we relook at the history and forecasted FHA claim rates (Exhibit 2) and the economic environments (Exhibit 1) that caused them, it is clear that the FHA should establish a capital threshold that reflects a more risk-based probability of stressed losses in the future. Exhibit 3 illustrates the number of endorsement years that are estimated to experience the indicated ultimate claim rate. Over roughly a thirty-year period 13 of the endorsement years have an ultimate claim rate greater than 10%. A simple probability distribution calculation would suggest that FHA should expect an ultimate claim rate greater than 15% more than 20% of the time.

In addition to reflecting the risk of more adverse economic outcomes, the FHA should be allowed to establish loss reserves and account for estimated loss liabilities prior to determining its capital ratio or other assessment of its financial strength. The establishment of loss reserves for currently delinquent borrowers for example is more transparent to estimate because these reserves are calculated using current market and economic conditions. Loss reserves are a critical part of determining the actuarial health of any insurance fund and should be part of the MMIF capital assessment to give Congress a more accurate view as to the capital adequacy of the FHA's single family operations.

RECOMMENDATIONS AND CONCLUSIONS

The mortgage insurance industry has weathered many storms since 1934 when the National Housing Act was passed in 1934 to create the FHA and make better housing available to low- and moderate-income families and 1957 when the private mortgage insurance industry was established to supplement the financing of affordable housing with private capital put at risk. Since the early 1980s when I began working in this industry I have witnessed multiple economic downturns which created tremendous losses for both private mortgage insurance companies and government run funds at both the state and federal level. It is therefore important to continue to work diligently in protecting this very important housing program. To that end I recommend that the FHA evaluate and adopt many of the private mortgage insurance statutory accounting provisions described above, better understand and modify their exposures to those that specifically support their mission and retain the necessary capital that is required to protect the program now and for the next economic downturn that will most definitely occur again.

QUALIFICATIONS AND LIMITATIONS

For this testimony, I have relied on data and other information provided in the public domain. I have not audited or verified this data and information. If the underlying data or information is inaccurate or incomplete, my testimony may likewise be inaccurate or incomplete. I have significant expertise in the evaluation of mortgage credit risk and mortgage insurance and I have been assisted with my testimony by staff and peer reviewers who are Members of the American Academy of Actuaries, Fellows of the Casualty Actuarial Society and/or also have significant expertise in the evaluation of mortgage insurance.

Additionally, Milliman has not performed an exhaustive review of the FHA's MMIF ultimate claims paying ability and therefore are not expressing an opinion on the MMIF's financial condition.

Any reader of this report must possess a certain level of expertise in areas relevant to this testimony to appreciate the significance of the assumptions and the impact of these assumptions on the illustrated results. The reader should be advised by, among other experts, actuaries or other professionals competent in the area of actuarial projections of the type in this testimony, so as to properly interpret.

♦ ♦ ♦ ♦ ♦

Thank you for inviting me and for your consideration of my views. I would be pleased to answer any questions from the Subcommittee membership.

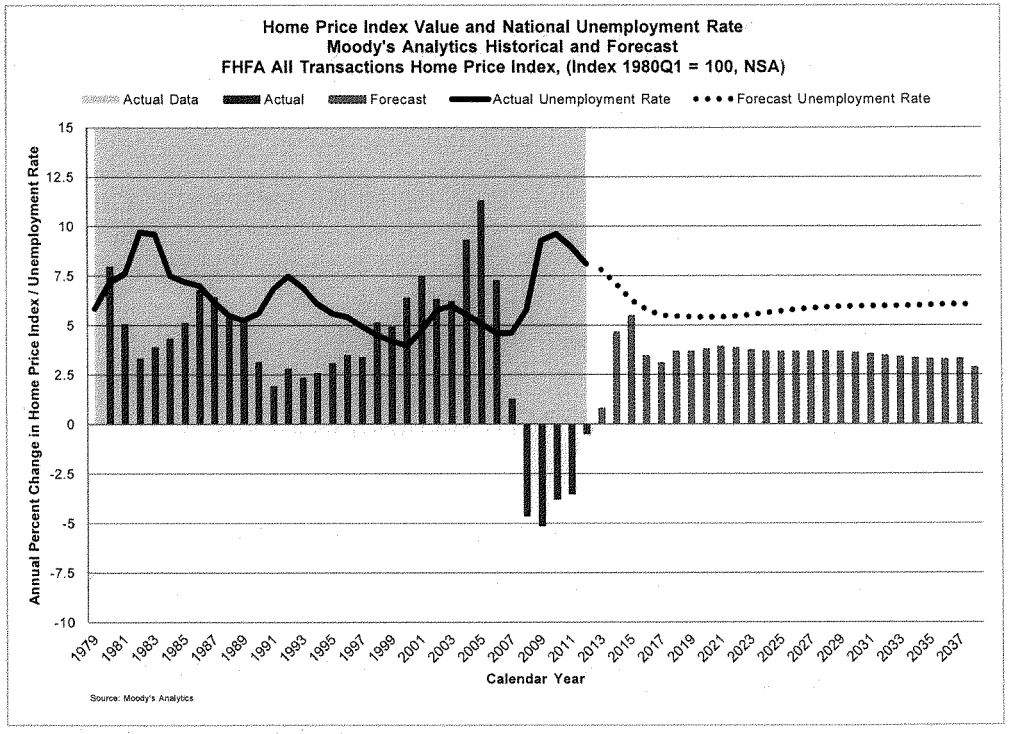
Respectfully submitted,

Kenneth A. Bjurstrom
Principal and Financial Consultant
Milliman, Inc.

KAB/sbs

March 12, 2013

Exhibit 1


Home Price Index Value and National Unemployment Rate
Moody's Analytics Historical and Forecast
FHFA All Transactions Home Price Index, (Index 1980Q1 = 100, NSA)
Actual Data
Actual
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Forecast Unemployment Rate
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Calendar Year
Source: Moody's Analytics

Exhibit 2

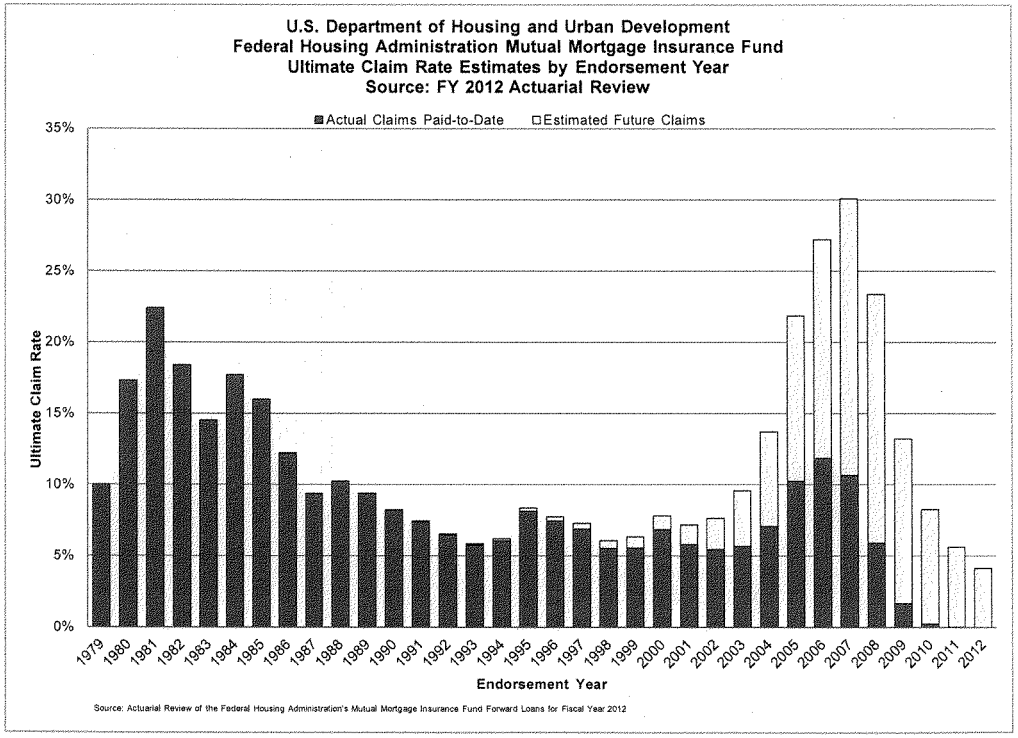

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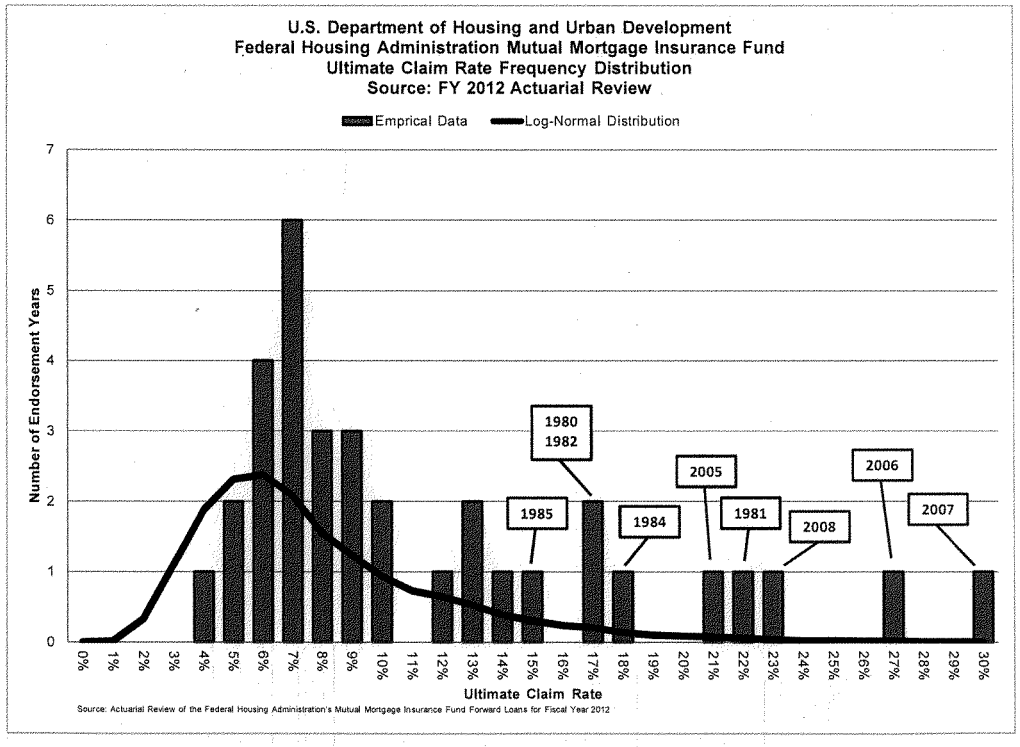
Exhibit 3



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POTOMAC PARTNERS LLC

The Power of Partnership in Washington

Testimony of
Brian Chappelle
Partner, Potomac Partners LLC
Washington D.C.

Hearing before the U.S. House of Representatives
Committee on Financial Services
Subcommittee on Housing and Insurance
on
"Mortgage Insurance: Comparing Private Sector and Government-Subsidized Approaches"
Wednesday, March 13, 2013

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, thank you for the opportunity to testify on the role of the Federal Housing Administration.

In my testimony, I will address the three issues outlined in your letter. They are:

- Mechanics of the mortgage insurance business and FHA
- Discussion of whether FHA's policies and practices thwart efforts by the private sector to revive and strengthen the free enterprise system
- Legislative and regulatory suggestions to enhance FHA, protect taxpayers and facilitate the return of private capital

I believe that a strong and viable private mortgage insurance (MI) industry is an integral part of the mortgage market. However, I also believe that the MIs' current problems have little do with the Federal Housing Administration.

Before addressing the specific issues listed above, I would like to discuss, what I believe, is a more pressing problem for the mortgage market and the broader economy: the over-all weakness of the purchase mortgage market. This problem affects policy considerations for FHA, the MIs and the Government Sponsored Enterprises (GSEs). Just last Friday, in a speech to the Mortgage Bankers Association of America, Federal Reserve Board Governor Elizabeth Duke highlighted the severity of this problem, noting that "purchase mortgage originations hit their lowest level since the early 1990s".

Younger, lower income and minority homebuyers are being particularly hard-hit by these troubling purchase numbers. According to Governor Duke, "from late 2009 to 2011, the fraction of individuals under 40 years of age getting a mortgage for the first time was half of what it was in the early 2000s". She added that since 2007, there has been "a fall of about 90% (in purchase originations) for borrowers with credit scores between 620 and 680". The Federal Reserve's Bulletin: Mortgage Market in 2011, which analyzed Home Mortgage Disclosure Act (HMDA) data, also indicates that lower income and minority homebuyers saw the steepest declines in homeownership activity. Link:
http://www.federalreserve.gov/pubs/bulletin/2012/articles/HMDA/default.htm

At the same time, "all cash" sales approached 30% of all purchase transactions in 2012 according to the National Association of Realtors. DataQuick, a mortgage and real estate information firm, found that 32% of all purchase transactions in California were "all cash" in 2012. *In other words, the private sector has returned to the housing market, just not to the mortgage market.*

The disappointing purchase activity (which is also seen in FHA and GSE purchase volumes) and the explosive growth in "all cash" sales raise serious concerns about the mortgage market. Unless policymakers address these concerns, I am worried that we may well be moving backwards towards a housing market where homeownership is limited to those who are wealthy (or have wealthy parents) and a dwindling few whose credit is stellar enough to qualify for a mortgage. At the same time, there will be an increasing number of renters who, while creditworthy, lack the resources to purchase a home. I believe that we must first solve this challenge before worrying about carving up a depressed purchase mortgage market.

The main points of my testimony are:

1. **The fundamental problem with the current mortgage market is not that FHA is doing too many purchase loans but that combined (FHA, the GSEs and the private mortgage insurers) are not backing enough purchase mortgage originations.**

Despite the fact that the government is reportedly 90% of the mortgage market, FHA and Government Sponsored Enterprise (GSE) purchase activity is running well behind historical levels. FHA's FY 2012 purchase volume was 13 percent below FHA purchase activity in FY 2000 when FHA's share was in line with historical norms. FHA purchase activity has fallen steadily since FY 2010 and its FY 2012 volume was 34 percent below FY 2010 levels.

Fannie Mae and Freddie Mac's purchase activity is even more disappointing. The GSEs together have barely backed more purchase loans than FHA since 2009 and that only occurred because of recent FHA's declines as part of its effort to assist the recovery of the private mortgage insurers. They historically acquired multiples of FHA's purchase activity. It is estimated that the GSEs' combined purchase volume is roughly 50% of pre-bubble levels.

Home Mortgage Disclosure Act (HMDA) data corroborates this problem for the broader mortgage market. U.S. total purchase transactions have declined almost 50 percent from 4.79 million loans in 2000 to 2.42 million loans in 2011 (latest year available) and based on Governor Duke's speech, there is little optimism for improvement in 2012.

2. **FHA's performance has improved significantly since the housing crisis.**

The Committee was rightly concerned about the FY 2012 Actuarial Review's headline number of negative $13.5 billion for the forward mortgage program. However, a closer look at the independent actuary's analysis confirms that FHA's problems are concentrated in older books (FY 2005 – FY 2008), which are 13% of FHA's portfolio. Recent books (FY 2010 – FY 2012), which are 58% of FHA's portfolio, are projected to perform better than any three-year period of FHA underwritten loans in more than 30 years. Despite the $28 billion of negative adjustments in the audit, the projected cumulative claim rate of the FY 2010 – 2012 books actually improved in the FY 2012 audit to a combined cumulative claim rate of 6.3% (1 in 16 loans). Each of the FY 2011 – FY 2019 books are projected to have cumulative claim rates below 5.7%. No earlier books in over 30 years have projected claim rates below 5.7%.

Also encouraging is the fact that there has been improvement in the economic factors on which the actuarial review was based and they should have a positive impact on future projections. In particular, home price estimates have improved significantly since the FY 2012 Actuarial Review was completed.

The Actuarial Review was based on an estimate of a less than 1% increase in home prices in 2012. This estimate has turned out to be very conservative. S&P/Case-Shiller Home Price Indices released on February 26th stated: "The national composite posted an increase of 7.3% for 2012." Core Logic's Home Price Index also found that home prices increased 9.7% in January 2013 on a year-over-year basis.

3. **FHA mortgage and borrower income data show that FHA remains focused on its mission of primarily serving lower income homebuyers.**

For all the attention given FHA's maximum mortgage amounts, the data shows that FHA activity is concentrated in lower priced homes. FHA's median loan amount for purchase transactions was $147,000 in 2011 according to the Federal Reserve Bulletin mentioned earlier. Seventy-one percent of FHA loans insured in 2012 were below $200,000, which is also below the FHA base limit of $200,160 that was in effect prior to the enactment of the Economic Stimulus Act (ESA) of 2008.

At least 80% of FHA loans insured in 2012 had mortgage amounts *below* the maximum mortgage amount that was in effect prior to ESA. (The FHA maximum mortgage limit in high cost areas was up to $362,790.)

FHA's median borrower income was $56,000 in 2011 according to the Federal Reserve's HMDA analysis. FHA's median income was closer to the U.S. median household income in 2011 than it was in 1971. In 2011, FHA's median income was 12% higher than the U.S. median household income ($50,050). In 1971, FHA's median income was 22% higher than the national median income according to a Government Accountability Office (GAO) report published in 1994. Link: http://www.gao.gov/assets/80/78805.pdf

4. **FHA has taken reasonable steps to facilitate an increase of private mortgage insurance activity.**

As the above data shows, FHA's current higher mortgage limits are a very small part of its business or the MIs' problem. In addition, since FHA has raised mortgage insurance premiums five times in recent years (with a sixth increase is coming in April 2013), any pricing disparities have already been addressed.

The private mortgage insurers recognize FHA's efforts to assist them. Here is what one MI executive said in a public filing last year.

> "the FHA's current premium pricing, when compared to our current credit-tiered premium pricing (and considering the effects of GSE pricing changes), may allow us to be more competitive with the FHA than in the recent past for loans with high FICO credit scores."

This statement was made prior to the announcement of the FHA premium increase that takes effect next month.

There are others factors affecting MI business over which FHA has no control. Foremost among those are the pricing policies of the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac. In particular, Fannie Mae and Freddie Mac's charging of loan level pricing adjustments (LLPAs) on loans with credit scores below 700 has severely curtailed MI purchase activity. To address this problem, the MIs must demonstrate to the GSEs that these fees are no longer necessary on loans backed by the private mortgage insurers. The net effect of LLPAs is the double charging of fees to homebuyers (MI premium and LLPAs).

In addition, if FHFA continues to increase guaranty fees as part of its effort to "contract" the role of the GSEs, this policy will have a direct impact on the MI purchase activity since MI loans are primarily purchased by the GSEs.

In the current environment, FHA cannot be expected to keep raising its own fees (beyond what is necessary to maintain actuarial soundness of the Fund) in light of the alarming problem in the purchase mortgage market articulated by Governor Duke. FHA must balance its efforts to assist the private MIs while addressing the current market reality that not enough purchase mortgages of any kind are being made.

5. Mortgage lenders have significant risk in the FHA program.

Mortgage lenders have taken the unprecedented step of adding their own underwriting restrictions (called credit overlays) on top of FHA lending requirements to protect their firms from liability.

This point can be boiled down to the following question:

Why would FHA lenders add credit overlays (additional underwriting criteria) on top of FHA's requirements when the loan is 100% insured by the government?

Much like doctors practice defensive medicine (i.e. requiring more tests to avoid lawsuits), mortgage lenders have adopted defensive lending (i.e. raising eligibility requirements on new originations to protect their companies from risk).

In her testimony before this Committee last month, FHA Commissioner Carol Galante acknowledged the impact of this problem on FHA's ability to serve many lower income families.

With this information as a backdrop, I will now address your three specific questions.

I. Mechanics of the Mortgage Insurance Business and FHA

As a former FHA official, I will address this issue from FHA's perspective. In this regard, it is first important to remember that FHA is an insurance program and like any successful insurance program, it needs to spread its risk. Just like an auto insurer could not be limited to drivers under the age of 25, FHA cannot be targeted only to higher risk borrowers.

FHA has an even more daunting task than your typical insurer. Its mission is two-fold:

- To serve borrowers not adequately served by the private sector
- To operate at no expense to the American taxpayer

If those goals were not enough, FHA is asked to accomplish them without encroaching on the private sector.

FHA loans have a Government guarantee

The principal difference between FHA and private mortgage insurance industry, of course, is that FHA loans have the backing of the full faith and credit of United States government. This difference has existed since the modern day private mortgage insurance industry reemerged in the 1950's.

To achieve the delicate balance between FHA's mission and fiscal responsibility and minimize overlap with the private insurers, there are three long-standing features of the FHA program.

FHA's premium structure reduces overlap with the private mortgage insurers

Instead of using risk-based pricing that is an integral part of private insurance and would make FHA insurance more competitive for borrowers with better credit characteristics, FHA has always charged all borrowers the same premium regardless of credit characteristics. Charging the same premium to all borrowers produces a type of cross-subsidization in which lower risk loans help to offset the losses associated with loans having higher risk characteristics.

More important for the deliberations of the Committee, a uniform premium structure also discourages borrowers with lower risk factors from using the program. Many have encouraged FHA to implement risk-based pricing. However, risk-based pricing would increase FHA's competitiveness on higher quality loans thereby exacerbating the concerns of the Committee about FHA's role.

At the same time, however, if these loans with higher credit characteristics were completely removed from the program, FHA would either have to charge even higher premiums to the families that need FHA financing the most to offset the lost revenue or require taxpayer assistance. Neither is an acceptable alternative.

FHA uses reasonable mortgage limits to target activity

The Economic Stimulus Act (ESA) of 2008 temporarily increased FHA's base limit to $271,050 and the maximum mortgage limits in high cost areas up to $729,750 to ensure liquidity in the mortgage market. Despite the increase in eligible mortgage limits, FHA data shows that the higher mortgage limits are used very infrequently. In 2012, at least 80% of FHA loans were made below the limits that were in place prior to the enactment of ESA in 2008. (The base limit was $200,160 and the high cost area limit could go up to $362,790.)

Here are some other statistics that demonstrate the minimal impact of the higher loan amounts.

- 1.6% of FHA 2012 originations are above $500,000 (Link: https://entp.hud.gov/sfnw/public/
    - Over 50% are in California.
    - 3.5% of FHA 2012 originations are above $400,000
    - 9% of FHA 2012 originations are above $300,000
- The vast majority of FHA originations are below $200,000
    - 71% of FHA 2012 originations were below $200,000
- FHA insured more loans under $50,000 in 2012 than it insured over $500,000.
- FHA insured twice as many loans under $100,000 in 2012 than it insured over $300,000.

FHA's median loan amount for purchase loans was $147,000 in 2011 according to the Federal Reserve Bulletin.

To provide some historical context about FHA mortgage limits, they were four times the median sales price at FHA's inception in 1934. While no one would expect FHA's limits to remain that high today, it is noteworthy that FHA mortgage limits were 150% of the median sale price for existing homes well into the 1970's. Accordingly, the base loan limit in effect today ($271,050) is comparable to the mortgage limit in the 1970's.

Why are having some higher balance loans important to the financial soundness of the program?

Higher balance loans perform better than smaller loans.

- FHA loans over $400,000 have a 33% lower early default and claim rate than loans under $200,000 (Neighborhood Watch data).
    - Loans over $500,000 perform even better.
- FHA actuarial reviews confirm these findings.

    - Every recent FHA audit has included a statement similar to this one from the FY 2011 audit:

      "FHA experience indicates that more expensive houses tend to perform better compared with smaller houses in the same geographical area, all else being equal. Larger loans incur claims at a lower rate and in those cases where a claim occurs loss severity tends to be lower."

The data shows that having some larger balance loans benefits the Fund and reduces risk for the taxpayer. The data also shows FHA made a very small percentage of high balance loans. I believe FHA's uniform premium structure discourages borrowers purchasing more expensive homes from using the FHA program.

FHA provides 100% insurance coverage

Some are recommending that FHA reduce its insurance coverage to promote "skin in the game". This issue has been raised many times in the past. In fact, the Government Accountability Office

(GAO) prepared a 1997 report entitled "Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages". Link: http://www.gao.gov/archive/1997/rc97093.pdf

The GAO Report concludes:

> **"If FHA's insurance is reduced and lenders become responsible for the risk associated with the uninsured portion of loans, lenders will likely make fewer and more costly FHA loans."**

As I noted earlier, lenders are already adding "overlays" (additional underwriting requirements) on top of FHA requirements. Lenders would only add more overlays if the insurance coverage is reduced making it even more difficult for many creditworthy families to qualify for a mortgage.

The VA program has also been mentioned as a possible model since it has reduced coverage (generally around 25%) and lower delinquency rates. However, the lower delinquency rates likely have more to do with the better borrower characteristics than the reduced coverage.

- VA loans have much higher credit scores.
  - In 2004 – 2007, VA had median credit scores of about 680 when FHA's were around 630-640.
    - As both FHA's and VA's credit scores have improved in recent years, the difference has declined.
      - In FY 2011 and FY 2012, the VA's median score was 719 and FHA's was close to 700.
- Veterans have much higher incomes than FHA borrowers.
  - In 2011, according to 2011 HMDA data, veteran income is more than 25% higher than the income of FHA borrowers.
- Veteran borrowers, because of their military backgrounds, have always been seen as more experienced in handling their financial obligations than FHA borrowers.

With the purchase mortgage market already depressed, changing FHA's insurance coverage would exacerbate the program.

Mortgage lenders have significant risk in the FHA program

There are three key reasons why lenders added credit overlays (additional underwriting requirements on top of FHA rules) in the FHA program. They are:

- Enforcement risk
  - FHA, the HUD Inspector General (I.G.) and the Department of Justice (DOJ) have increased scrutiny of FHA lenders. When FHA terminated one of its largest lenders in August 2009, that action reverberated throughout the industry.
  - Public display of early default and claim rates in Neighborhood Watch deters bad behavior.
    - In addition to potential FHA suspension for high early default rates, business partners (warehouse banks and purchasers of servicing) make business decisions based on this performance data.

- Indemnification risk
  - Mortgage lenders are held accountable for making loans that do not meet FHA standards. When FHA determines that a loan was not originated properly, it can require the lender to absorb FHA's loss.
- Reputation or "headline" risk
  - In addition to any penalties imposed by HUD, the I.G. or the DOJ, the public announcement of sanctions can have a severe impact on a firm, particularly large financial institutions when articles appear on the front page of the major newspapers in America.
- Financial risk
  - The ultimate economic value of an FHA loan is in the monthly servicing fee (an annuity-like payment) on a performing loan. This is in contrast to subprime and Alt-A loans in which the revenue was in the origination of the loans. Accordingly, if an FHA loan doesn't perform, the lender loses significant revenue. This is particularly true in transactions in which large servicers buy originations from smaller originators by paying an upfront fee (approximately 2% of the loan) to the originator shortly after closing.

Mortgage lenders began imposing credit overlays in early 2008. See the attached chart documenting the shift in the distribution of FHA credit scores starting in early 2008. In 2007 4Q, 47% of FHA loans had credit scores below 620. That percentage dropped steadily in every quarter until it bottomed out below 5% where it remains today. On the other hand, the percentage of borrowers with credit scores above 680 has increased every quarter since 2007 4Q. The percentage of FHA loans with high credit scores exceeded 55% in 2009 3Q and is still there today.

This data and the imposition of lender credit overlays categorically refute the allegation that FHA has replaced subprime lending and that FHA lenders do not have significant liability in the program.

FHA is burdened with administrative requirements, inflexibility and uncertainty that discourage participation

Here is what GAO said in 2007 about processing FHA loans.

> "According to mortgage industry officials we interviewed, processing FHA- insured loans was more time consuming, labor intensive, and costly than processing conventional mortgages."

The GAO report also noted that FHA has limited flexibility in hiring and compensating staff or investing in technology:

> "Although FHA has taken actions to enhance key tools and resources, it operates in a highly competitive environment in which other market participants have greater flexibility to hire and compensate staff and invest in information technology, which enhances their ability to adapt to market changes."

FHA has also been saddled with other requirements that make it more complicated than conventional lending. For example, by law, FHA is required to have lenders provide homebuyers with a disclosure (Informed Consumer Choice) stating that loans with private mortgage

insurance may be cheaper than FHA insurance. FHA transactions also have a tiered pricing restriction. Mortgage lenders cannot charge more than a two discount point differential on any FHA loan regardless of the cost of originating a particular loan.

Throw in uncertainty about the availability of FHA lending in times like sequestration or the expiration of Continuing Resolutions (e.g. March 27th) and there are plenty of reasons why mortgage lenders avoid FHA lending when they have a choice.

To sum up, FHA's "competitive advantage" (i.e. government backing) has existed since 1934. However, there are certainly other factors that discourage FHA lending particularly to borrowers with better credit characteristics.

II. Discussion of whether FHA's policies and practices thwart efforts by the private sector to revive and strengthen the free enterprise system

I do not believe that FHA's policies "thwart efforts by the private sector". However, there are factors affecting MI business over which FHA has no control.

In the aftermath of the housing crisis, concerns about FHA's advantages have centered on FHA's "pricing ". Of course, FHA has increased mortgage insurance premiums five times. FHA also assisted the MIs' competitiveness by primarily raising the annual premium (almost 1%), which effectively raises the interest rate on an FHA loan by that amount.

The concern about pricing should be directed at the policies of the Federal Housing Finance Agency, Fannie Mae and Freddie Mac. In particular, the charging of loan level pricing adjustments has severely curtailed MI purchase activity. The MIs must demonstrate to the GSEs that these fees are no longer necessary on loans backed by the private mortgage insurers.

In addition, while the MIs believe they pay all legitimate claims, mortgage lenders are upset by the significant increase in rescissions (i.e. claim denials). Rescissions increased from 5% -10% to over 20% in 2008 -2010. While many rescissions may have been justified, mortgage lenders believe some were not. Just like loan repurchases have damaged lender relationships with the GSEs, rescissions have soured the relationship with the private mortgage insurers.

Finally, the MIs made necessary business decisions in pulling back from the mortgage market, particularly in the hardest-hit areas. Once these markets stabilized with the help of FHA financing, the MIs gradually returned to the marketplace. However, the MIs should not expect their market share to return immediately to pre-bubble levels.

III. Legislative and Regulatory Suggestions

I submit the following recommendations for the Committee's consideration.

The cause of credit overlays must be addressed

The mortgage industry, rightly or wrongly, believes that the government is no longer taking the credit risk but instead, is transferring a portion of this risk to mortgage lenders through repurchases, indemnifications, lawsuits, settlements, etc. The reputation or "headline" risk associated with public disclosure of legal settlements only exacerbates the impact.

As I noted earlier, the mortgage industry has taken the unprecedented step of adding their own underwriting restrictions (called credit overlays) on top of government lending requirements to protect their firms from this liability. Much like doctors practice defensive medicine (i.e. requiring more tests to avoid lawsuits), mortgage lenders have adopted defensive lending (i.e. raising eligibility requirements on new originations to protect their companies from risk).

FHA leadership is acutely aware of this problem and has been trying to address the industry's concern about risk without undermining the safety and soundness of the program. FHA has made changes to the Neighborhood Watch program and is updating program handbooks to provide more transparent guidance in an effort to encourage lenders to reduce overlays in the FHA program. (It is recognized that FHFA has also taken steps to address this problem in GSE lending.)

Unfortunately, lender reluctance to follow FHA's underwriting criteria is more complicated than reaching an understanding between FHA officials and the industry. The Department of Justice and the HUD Inspector General have also been active participants in the enforcement of FHA rules. While the full weight of the law should be brought against lenders that knowingly commit fraud or abuse, there is growing concern in the industry that procedural errors in the processing of groups of cases can lead to settlements of hundreds of millions of dollars and even more importantly reputation risk through front page articles in the major newspapers of the country. The mortgage industry increasingly believes that the only way to protect their companies from this procedural liability in the current environment is to tighten up on new originations (hence overlays).

No one expects or wants the government to stop penalizing lenders that knowingly commit fraud or serious violations of program and underwriting requirements. These abusive lenders damage the marketplace in addition to inflicting financial cost to the program.

I offer the following ideas as part of the discussion on this critical subject. I would recommend that a special meeting be convened with the Executive Branch and the industry to address this issue.

One issue that could be considered is the type of errors that precipitate a False Claims Act violation. It would also be helpful if the government provided detailed explanations of specific violations that precipitated these penalties. The impression in the industry is that procedural mistakes (i.e. "process fouls" or "foot faults") are the cause of these penalties.

In addition, it would also be helpful if auditors would update lenders on the status of investigations to the extent practical. Obviously, in cases involving widespread fraud, such updates are inappropriate. However, I am aware of instances where lenders received subpoenas a year ago or longer and have not heard any word. In the interim, lenders have added overlays to protect their firms going forward.

Finally, it should be understood that the marketplace makes a judgment about the fairness of actions and penalties. If they believe the government actions are excessive, the industry would step-up overlays to protect their companies.

Expand Neighborhood Watch to include information on individual loan originators

The public display of early default and claim performance system in the Neighborhood Watch system has been an invaluable tool for self-policing in the industry. Business partners (warehouse banks and aggregators) have used this information to encourage FHA loan quality.

I believe expanding this tool to individual loan originators will have an even more profound impact on loan quality. If loan originators know that their company as well as others in the industry can see how well their originations perform, they will be much less willing to take improper actions.

When a lender terminates a loan originator for improper conduct, the loan officer can simply move to another lender. Their former employer would be unwilling to say anything because of legal concerns. However, if this originator's performance were visible to other lenders, I believe and many lenders have told me that it would have a dramatic impact on fraud and abuse.

Conclusion

The fundamental problem with the mortgage market today is not that FHA (or Fannie Mae and Freddie Mac) are making too many purchase loans, but that the total purchase mortgage market is not making enough loans.

The performance of FHA loans insured since the private mortgage market collapsed shows that FHA ha officials have acted responsibly in balancing FHA's dual mission of serving those not able to find financing from other sources and avoiding risk for the American taxpayer.

FHA has also taken the appropriate steps to facilitate the return of private capital. However, FHA is also rightly concerned about making additional changes in light of the weak purchase mortgage market.

The MIs benefited from FHA's efforts to provide liquidity to the mortgage market at the height of the crisis in 2008 and early 2009. By helping to stabilize home prices, FHA reduced the size of MI losses. However, as the FHA Actuarial Review shows, FHA did incur significant losses on these loans. Like any insurance company, FHA must be able to spread its risk within reasonable limitations to perform this role in the future without requiring taxpayer assistance.

There is still more work to be done to ensure that all creditworthy Americans are able to buy a home. Placing more restrictions on FHA at this time will only make it more difficult for many families to qualify for a mortgage. Equally important, they could increase financial risk for the FHA program and the American taxpayer.

Exhibit A-4: Borrower Credit Score Distribution on New Endorsements

FHA Single-Family Mortgage Insurance

Borrower Credit Score[a] Distribution on New Endorsements[b]

By Fiscal Year (FY) and Quarter

(Shares in each row add to 100%)

Fiscal Year	Quarter	Credit Score Categories						
		720+	680+	620+	580+	500+	300+	N/A[c]
2007	Oct-Dec	11.2%	10.9%	31.7%	22.5%	17.8%	1.2%	4.7%
	Jan-Mar	10.3	10.2	31.1	23.0	19.4	1.4	4.6
	Apr-Jun	9.9	9.6	30.6	23.5	20.4	1.5	4.6
	Jul-Sep	9.9	9.3	30.9	23.6	20.8	1.5	3.9
2008	Oct-Dec	9.3	9.1	31.2	23.9	21.3	1.7	3.6
	Jan-Mar	9.9	9.9	31.8	23.2	20.4	1.7	3.1
	Apr-Jun	15.2	13.2	35.6	20.9	12.2	0.7	2.2
	Jul-Sep	19.2	16.1	37.5	19.0	6.7	0.2	1.4
2009	Oct-Dec	20.5	17.2	37.6	18.7	5.1	0.1	0.8
	Jan-Mar	24.4	19.0	37.0	15.5	3.4	0.0	0.7
	Apr-Jun	29.7	21.3	38.3	8.5	1.5	0.0	0.7
	Jul-Sep	33.4	22.1	37.9	4.9	1.0	0.0	0.7
2010	Oct-Dec	33.6	22.5	38.6	4.0	0.7	0.0	0.6
	Jan-Mar	34.0	22.8	38.5	3.5	0.5	0.0	0.6
	Apr-Jun	35.1	22.7	38.5	2.7	0.4	0.0	0.6
	Jul-Sep	34.9	22.7	38.5	3.0	0.4	0.0	0.6
2011	Oct-Dec	37.2	23.3	36.2	2.5	0.3	0.0	0.5
	Jan-Mar	37.9	24.2	35.1	2.2	0.2	0.0	0.4
	Apr-Jun	35.5	23.9	37.6	2.6	0.2	0.0	0.4
	Jul-Sep	33.1	23.8	39.2	3.3	0.2	0.0	0.3
2012	Oct-Dec	33.0	23.9	39.3	3.2	0.2	0.0	0.3

Above 680

Below 620

[a] Credit scores are co-branded between the three major credit repositories (Equifax, Experian, Transunion) and Fair-Isaac Corporation. Values can range from 300 to 850. They are grouped here according to the "decision" score used for loan underwriting. That score represents the weakest borrower on a loan application when there are multiple applicants. Streamline refinance loans do not require full underwriting, and therefore, they are not represented here.

[b] Excludes streamline refinance loans.

[c] Borrowers Without credit histories can be underwritten for FHA Insurance using alternative criteria.

Source: Data from FHA, Mortgage Bankers Association, and CoreLogic; January 2012.

There has been a dramatic shift in the distribution of FHA credit scores since 2007

Written Testimony of Nat Shapo, Katten Muchin Rosenman LLP
House Financial Services Committee
Subcommittee on Housing and Insurance
Honorable Randy Neugebauer, Chairman
March 13, 2013

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee. Thank you for the privilege of appearing before you today regarding "Mortgage Insurance: Comparing Private Sector and Government-Subidized Approaches."

My name is Nat Shapo. I am a partner at Katten Muchin Rosenman LLP, where my practice is in litigation and insurance regulatory matters, and I am a lecturer in insurance law at the University of Chicago Law School. I had the honor of serving as the Illinois insurance commissioner from 1999-2003.

You have asked me to analyze the FHA mortgage programs from a regulatory perspective. Such analysis yields the unambiguous conclusion that FHA's operations and oversight ignore basic regulatory principles. Most importantly, the Mutual Mortgage Insurance Fund (MMIF) does not meet its very forgiving risk to capital legal standard, and the program has continued to write, and even expanded, its business at a time when it is impaired, insolvent, and extraordinarily under-capitalized. These are cardinal violations for any risk bearer and for the oversight thereof.

Background On Insurance Regulation

While there has been debate for centuries about its proper location (Federal or State), it is well settled in U.S. law and public policy that insurance regulation is a fundamental governmental responsibility. In its landmark ruling that insurance is interstate commerce and Constitutionally subject to Congressional oversight, the Supreme Court explained that "Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business.

Insurance touches the home, the family, and the occupation of almost every person in the United States."[1]

Such a business requires significant regulation, the Court has recognized. "[T]he business of insurance has … a reach of influence and consequence beyond and different from that of the ordinary businesses of the commercial world. … The contracts of insurance may be said to be interdependent. … It is … essentially different from ordinary commercial transactions and … is of the greatest public concern."[2]

Insurance is a common fund. Public confidence in that common fund's financial stability is a paramount policy consideration. "[T]he effect of [contracts of insurance's] relation is to create a fund of assurance and credit, the companies becoming the depositories of the money of the insured, possessing great power thereby, and charged with great responsibility. How necessary their solvency is, is manifest."[3]

Indeed, supervising the solvency of risk bearing insurers is the single most important function of the State insurance departments, vested with primary regulatory oversight of most lines of insurance under the McCarran-Ferguson Act of 1945. Financial stress is the greatest calamity to threaten policyholders since the potential inability to pay claims directly calls into question the promise to pay at the heart of the insurance contract.

Solvency Regulation In The States

State regulation of insurer solvency is rigorous and complex, both with respect to standards and remedies. "[S]olvency regulation polices a number of aspects of

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[1] *U.S. v. Southeastern Underwriters*, 322 U.S. 533 (1944).
[2] *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389 (1914).
[3] *Id. Lewis* featured a closely divided Court on the Constitutionality of a State rate regulatory statute. The one thing that the majority and dissent agreed upon was the fundamental importance of solvency regulation. *See id.* (Lamar, J., in dissent) ("Regulatory statutes were, from time to time, adopted to protect the public against conditions and practices which were subject to regulation. The public had no means of knowing whether these corporations were solvent or not, and statutes were passed to require a publication of the financial condition.").

insurers' operations, including: 1) capitalization; 2) pricing and products; 3) investments; 4) reinsurance; 5) reserves; 6) asset-liability matching; 7) transactions with affiliates; and 8) management. Regulators police these areas by setting financial standards, monitoring insurers' compliance and financial condition, and intervening when necessary to enforce these standards and protect policyholders' interests."[4]

Much of the basic framework for tools and practices in State solvency regulation is established in a series of widely adopted National Association of Insurance Commissioners (NAIC) Model Acts and Regulations.

Risk To Capital Ratio

Capitalization is rightly listed first in any list of the priorities of an insurance solvency regulator. All States require insurers to establish and maintain a base level of minimum capital, usually in the low seven figures, but the rigor in the system devolves from risk to capital analyses and requirements.

The NAIC Mortgage Guaranty Insurance Model Act ("Model Act") provides a common template in the area at issue before the Subcommittee today. Section 12, Outstanding Total Liability, instructs that "A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty five (25) times its capital, surplus and contingency reserve." This is a commonly adopted measure.[5]

Risk to capital ratio requirements are a cornerstone of the solvency regulation of mortgage insurers. They provide an objective standard linked to the size of the insurer and its exposure to risk, and they at all times require that risk to be supported by presently ascertainable funds. If a company does not meet the 25:1

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[4] Robert W. Klein, "The Growing Sophistication of Solvency Policing Tools," *Journal of Insurance Regulation*, National Association of Insurance Commissioners, Winter 2000.

[5] *See, e.g.*, N.C. Stat. 58-10-125(a) ("a mortgage guaranty insurer shall maintain at all times a minimum policyholders position of not less than one twenty-fifth of the insurer's aggregate insured risk outstanding").

ratio—capital of at least 4% of its calculated outstanding liability—then it cannot be understood to possess an adequate base to support its exposure.

From a public policy perspective, it is essential to prevent troubled carriers from taking on yet more risk, in jeopardy of both existing and future consumers. Thus the Model Act requires that, "In the event that any mortgage guaranty insurance company has outstanding total liability exceeding twenty-five (25) times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds twenty-five (25) times its capital, surplus and contingency reserve."

The risk-to-capital ratio, a hallmark of solvency regulation generally, has been a key component of regulators' response to the financial crisis during the last five years. The prohibition on writing new business—a hallmark for regulation of insurers who have become stretched too thin—has been enforced against multiple mortgage insurers[6] and has ensured that companies' troubles do not become catastrophic.[7]

By contrast, as well documented by a series of GAO audits, the FHA has far less stringent standards, and they have not been materially enforced in regulatory fashion.

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[6] See, e.g., http://www.pmi-us.com/; http://www.rmic.com/ratesguides/releasenotes/Documents/RMIC-Customer-Announcement_8%203%2011.pdf

[7] Even the exceptions made in deference to the literally historically bad market demonstrate the rigors of the State regulatory system. For instance, North Carolina's statute now allows the Commissioner to "waive the requirement," but requires a written request "at least 90 days in advance of the date" the insurer expects to fall below the required ratio, spells out a dozen factors to be considered, cannot be waived for more than two years, and is subject to any conditions the Commissioner might impose. In other words, it is a closely supervised process on paper—and has been in practice as well, as the Commissioner has tightly monitored, and then cut off, courses of writing new business outside the statutory baseline.

The baseline requirement is a 50:1 ratio of risk to capital, meaning that the program is only required to keep 2 cents on hand for every dollar of risk.[8] This 2% requirement is half that found in the States.

Loose as it is, though,[9] the restriction is unambiguous—and the biggest problem from a regulatory perspective is that there is the statutory standard has not been enforced in a meaningful way. As detailed by the GAO, "According to annual actuarial reviews of the insurance fund, the capital ratio fell from about 7 percent in 2006, to 3 percent in 2008, and below 2 percent in 2009."[10] Rather than halt new business in 2009, though, FHA only continued to write substantial amounts of new business. "[S]ince 2008, the economic value has fallen as the insurance-in-force has risen, dramatically lowering the capital ratio."[11] The amount of new risk assumed has been dramatic. "In 2006, FHA insured approximately 4.5 percent of purchase mortgages. At its peak in 2009, it insured 32.6 percent of purchase mortgages."[12]

The results have been predictable—and exactly what insurance regulation is designed to prevent: the deepening of a crisis, and a full-blown negative balance

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[8] GAO-13-400R at 7. "The Omnibus Budget Reconciliation Act of 1990 required the HUD Secretary to ensure that FHA's Mutual Mortgage Insurance Fund attained a capital ratio (the ratio of the insurance fund's economic value to insurance obligations) of at least 2 percent by November 2000 and maintain[ ] at least that ratio at all times thereafter."

[9] My analysis focuses on MMIF's failure to meet its own standard and the implications of that from a regulatory perspective. I could, but do not at this time, belabor the (substantial) extent to which the FHA's standards are weaker than those observed by private insurers. Not only are the risk to capital numbers far less stringent, but FHA immediately books its premiums up front as assets instead of liabilities while private carriers start analogous premium as liabilities, only to be amortized into income over the life of the risk. And FHA counts as capital the present value of future revenue, a speculative practice not followed by private regulated carriers whose capital only includes the value of present tangible assets.

[10] GAO-13-400R at 7.

[11] Id.

[12] Id. at 3.

sheet position. As explained by the GAO, "In 2012, the capital ratio fell below zero to negative 1.44 percent."[13]

Perhaps most telling is the fact that "The 2012 actuarial analysis projects that the capital ratio will be positive by 2014"[14]—an extended period of insolvency. And the Fund will not meet its required risk-to-capital ratio for the better part of a decade. It fell below 2% in 2009, remains so impaired, "and will go above 2.0 percent in 2017."[15]

Operating In A Hazardous Condition

One of the most powerful tools in State regulators' kit is the widely adopted NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition.

The Hazardous Financial Condition Regulation wields a powerful remedies section, "Commissioner's Authority." The regulator may require the insurer to take a dozen different steps, including "Reduce, suspend or limit the volume of business being accepted or renewed"; "Increase the insurers' capital and surplus"; "Limit or withdraw from certain investments"; "Correct corporate governance deficiencies"; etc.

The triggers for application of these remedies are instructive. Found in the "Standards" section, they are the types of the most basic red flags which alert the financially savvy observer to solvency dangers in a risk bearing insurer. The MMIF's operations trigger several of these, including:

- "Adverse findings reported in financial condition and market conduct examination reports, audit reports, and actuarial opinions, reports or summaries." A slew of authoritative audits have published a litany of such adverse findings.[16]
- "Whether the insurer's operating loss in the last twelve-month period or any shorter period of time … is greater than … 50% … of the insurer's

[13] Id. at 7.
[14] Id. at 8.
[15] Id.
[16] *See, e.g.*, id.

remaining surplus." The Fund has a negative economic value, no remaining surplus, and thus an operating loss greater than half its surplus.

- "Whether the insurer's operating loss in the last twelve-month period or any shorter period of time … is greater than … 20% … of the insurer's remaining surplus." Same as above; the Fund has negative economic value and no surplus.
- "Whether the insurer has grown so rapidly and to such an extent that it lacks adequate financial and administrative capacity to meet its obligations in a timely manner." The Fund increased its market share by 700% precisely as its risk to capital ratio plunged below its statutorily required level.[17]
- "Whether management has established reserves that do not comply with minimum standards established by state insurance laws, … sound actuarial principles and standards of practice." For four years, and four more projected, the Fund has not met its statutory capital reserve requirements.

These are all bread and butter regulatory standards, and the Fund's non-compliance is unambiguous.

FHA Fails The Most Fundamental Regulatory Benchmarks

Certainly FHA is not a private insurer and is not subject to State insurance department regulatory oversight. But it is operating in competition with such private insurers, and it is doing so in an insurance marketplace designed by Congress, under the McCarran-Ferguson Act, to be primarily overseen by State regulators.[18]

And the program itself since 1990 has been statutorily required to meet a minimum risk to capital ratio, subject since 2008 to an annual requirement to obtain an independent actuarial review of the economic net worth and soundness of the

[17] Id. at 5. "FHA's market share of all purchase mortgages increased from 4.5 percent in 2006 to a high of 32.6 percent in 2009."

[18] McCarran-Ferguson Act, 15 USC 1011 et seq. "Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest."

Fund.[19] Thus the Subcommittee's desire to seek an analysis of the Fund's operations under a regulatory framework seems well founded.

Such a regulatory analysis, in my opinion, demonstrates deep and fundamental problems. The MMIF is an insurance fund that has exceeded its statutory maximum risk-to-capital ratio for four years and is expected to continue to do so for another four; which is insolvent, and which is projected to remain so for at least two years; which has no surplus to compare to its operating loss; which increased its market share from 4.5% to 32.6% in three years; and which has been subject to numerous actuarial findings of inadequate capital.

It is operating in fundamental disregard for the basic principles of insurance solvency regulation, despite the clear suggestion to the public, created by the statutory requirements of minimum capital requirements and annual audits, that it follows such tenets.

FHA's explanations of its situation are further inconsistent with basic notions of insurance, proper risk analysis, and solvency regulation. Its presentations heavily rely upon treating the poorest, financial crisis years as essentially a quarantined anomaly which should not be allowed to control review of the MMIF balance sheet.[20] But the essence of insurance is that sometimes results are good, sometimes they are bad. That is particularly true of mortgage insurance, which is subject to extraordinary swings in losses.

To ask to be reviewed in a way that explains away a negative balance sheet and a projected eight year violation of a very forgiving risk-to-capital ratio requirement is something that a regulated company could never do. And that is not a technicality: A core mission of solvency regulation is to prevent risk bearers from expanding their exposure at the very time that their financial position is decaying.

FHA, of course, enjoys a key advantage which allows it to in a sense write its own rules. It explicitly relies on its limitless U.S. Treasury backstop to prop up

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[19] GAO-13-400R at 7.

[20] See Assistant Secretary Galante testimony of Feb. 13 ("Books of business originated from 2007-2009 continue to be the prime source of stress to the Fund. … In contrast, the actuary attests once again to the high quality and profitability of books insured since 2010.").

confidence in the program.[21] This seeming protection, however, may well have the effect of worsening a bad situation. State insurance regulations prevent insurers from attempting to write their way out of a crisis. The purpose of that is to prevent a total collapse.

The fact that such a calamity could ultimately be borne by the taxpayers clearly is a fiscal concern of Congress's. And its effect on an important market—and the consumers served therein—is a matter of substantial public policy concern now that MMIF's market share stands at more than one quarter of purchase mortgages.

Thoughts On Policy Implications Of FHA's Financial Results

As recognized by the Supreme Court and Congress, insurers maintain solvency by properly evaluating and classifying risk, correlating premiums to the likelihood and amount of claims. "[T]he legislative history of the McCarran-Ferguson Act strongly suggest[s] that Congress understood the business of insurance to be the underwriting and spreading of risk. Thus, one of the early House Reports stated: 'The theory of insurance is the distribution of risk according to hazard, experience, and the laws of averages.'"[22]

FHA has not run MMIF according to the basic principles of insurance. It has not evaluated hazards according to actuarial principles and correlated premiums to risk. It has not spread risk in a manner supported by financial wherewithal. And it

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[21] Id. at 2. "While the actuary's finding regarding the economic net worth of FHA's portfolio is obviously of very serious concern, it is not the determining factor for whether FHA will need to draw on permanent and indefinite budget authority from the Treasury. Any determination that such a draw is necessary will not be made until the end of FY 2013, and in any event, does not affect the full faith and credit of the Federal Government to pay any claims."

[22] *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979). "The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk. 'It is characteristic of insurance that a number of risks are accepted, some of which involve losses, and that such losses are spread over all the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it.' ... 'Insurance is an arrangement for transferring and distributing risk.'" *Id.*

plainly states that it does not live by the most basic rules that private insurers must—or die.

If MMIF was a private insurer, it would have been stopped from writing new business and in fact would have been placed in receivership. Instead, the program stands with a market share of over a quarter, and is reaping the benefits of an improving market denied to its competitors who have been placed in receivership, stopped from writing new business, and/or struggled to raise capital in a market distorted by the presence of a government-backed behemoth.

Ultimately, the policy determinations that the Subcommittee must make with respect to the Fund rest at the proverbial higher pay grade than mine. Proponents of FHA can certainly advocate for the social benefits purportedly derived from FHA's role in the marketplace both generally and during the financial crisis.

But to the extent that my thoughts are relevant, I think that this discussion must start from the basic insurance doctrine articulated by the Supreme Court. Insurance must be rooted in actuarial principles. Solvency must be paramount.

This is not just an ideological viewpoint. Insurance markets are no different than any others. While there is an essential social role to be played by this product, in a market which is designed to be primarily serviced by private providers, substantial government interference will yield the same results as it will in any other marketplace. Capital formation will be impaired. Competition will be distorted. Incentives will not align with healthy markets and the public good.

Most importantly, the very people whom government intervention is designed to help may be hurt. I have seen this many times in the insurance marketplace, when government programs like residual risk pools, put in place to try to help hard markets, have ballooned in market share and only ultimately distorted the market and destroyed any chance it had of pulling out of a crisis. New Jersey's automobile insurance marketplace, the subject of testimony in front of this committee in the past by me and others, provides such a cautionary tale.[23]

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[23] See, e.g., http://archives.financialservices.house.gov/media/pdf/061605ns.pdf; http://www.texaspolicy.com/center/economic-freedom/reports/shopping-solution; http://archives.financialservices.house.gov/media/pdf/033104po.pdf

While each line of insurance is different, the basic laws of economics and insurance are the same. In my view, the FHA mortgage insurance program is operating in a manner at odds with these immutable rules. It is taking substantial market share from private carriers at the same time when, if it were a true competitor playing by the same rules, it would be prohibited from writing new business. In doing so, it makes both obtaining business and attracting capital more difficult for regulated insurers, distorts the market as a whole, and deepens the spirals already in place both at the FHA and with private carriers.

It may be the choice of policy makers that the social benefits reaped in the process outweigh the financial risks, but that decision should be a considered one with an awareness of its consequences.

Thank you for inviting me and for your consideration of my testimony. I would be pleased to answer any questions from the Subcommittee membership.

Respectfully submitted,

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Testimony of Stephen Stelmach
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FBR Capital Markets & Co.

House Financial Services Subcommittee on Housing and Insurance Hearing on
"Private Mortgage Insurance: Comparing Private Sector and Government-Subsidized Approaches"
2168 Rayburn House Office Building
March 13, 2013
10:00 AM

Good morning,

My name is Steve Stelmach. I am a senior vice president at FBR Capital Markets & Co., an investment bank headquartered in Arlington, Virginia.

I would like to thank Chairman Neugebauer and Ranking Member Capuano for my invitation today.

Among the issues that the Subcommittee asked to be addressed today is the impact of the FHA's policies and practices on investments in private mortgage insurance.

This is a topic on which I can offer a unique perspective. In my role at FBR Capital Markets, I have 10 years of experience in advising our clients on the merits and risks of investing in particular industries and companies. My particular area of expertise is United States housing, mortgage finance and, relevant to this Subcommittee, private mortgage insurance.

FBR's clients are pension funds, endowments, mutual funds, and asset managers throughout the U.S. and Europe. Collectively, these investors manage assets in the trillions of dollars.

Having participated in countless conversations with these institutional investors over many years, I can attest that the actions of the FHA have a direct influence on investors' decisions to allocate or not to allocate capital to the private mortgage insurance industry.

Today, I would like to address three main topics on which investors tend to focus:

1) How the FHA has historically crowded out private capital.
2) How recent changes at the FHA have encouraged new capital into the market.
3) How FHA premium increases can have the impact of expanding mortgage availability.

How the FHA Has Historically Crowded Out Private Capital

First, on the issue of crowding out private capital:

The FHA has a fixed insurance premium structure, which means that borrowers are all charged the same insurance premium on each FHA-insured loan, regardless of creditworthiness. Until recently, this premium was at or below the rates charged by private mortgage insurers. Prior to the passage of the FHA Reform Act of 2010, the maximum premium the FHA could charge was just above one-half of a percent, or 0.55%. This premium, combined with down payment requirements less than those

necessary on loans with private mortgage insurance, higher FHA seller concessions, lower perceived repurchase risk for defaulted loans, and higher gain-on-sale margins, pushed lenders and borrowers into the FHA product. At its peak, FHA loans represented 90% of the market of insured mortgages.

With capacity constraints among mortgage originators and uncertainty over future liabilities, the creditworthiness of the average FHA borrower is much higher than historical levels. Currently, the average credit score for FHA-insured loans hovers around 700. This is safely in "prime" credit territory and well above the average FICO score for many low- and moderate-income households that the FHA has traditionally served. When the FHA premium was capped at 0.55%, the FHA charged a lower insurance premium for this prime-quality borrower than the premium charged by private mortgage insurers, making it exceedingly difficult for private mortgage insurers to compete for that business. As this trend persisted, private capital was hesitant to invest in mortgage insurers, who were at a competitive disadvantage relative to their government competition. As a result, the private mortgage insurance market share continued to shrink.

How Recent Changes at the FHA Have Encouraged New Capital to Enter the Market

Secondly, touching on the issue of the private mortgage insurance industry attracting additional capital, we see investor interest as very strong.

Following passage of the FHA Reform Act of 2010, the FHA was given the authority to raise annual premiums to 1.55% and, following a series of premium increases, the current FHA premium is 1.35%. Additionally, the FHA has taken steps to shore-up its finances, making FHA loans less attractive to higher creditworthy borrowers, expanding the market share for private mortgage insurance—backed loans.

Since the FHA began to institute premium increases in 2012, FBR has helped raise $550 million in capital for a new mortgage insurance company and recently participated in raising over $1 billion in capital for an existing mortgage insurance company. In total, the mortgage insurance industry has attracted nearly $3 billion in new capital in the last 12 months.

Notably, investors chose to invest this capital only after the FHA instituted premium increases.

Despite the sums raised in the past 12 months, they are a far cry from the roughly $20 billion of capital that the industry enjoyed only a few years ago before paying out billions of dollars of claims.

While much of the decline in industry capital was the result of these extraordinary claims that the industry has paid in recent years, investors have been hesitant to provide the industry capital due to persistent regulatory uncertainty—including GSE reform, FHA reforms, and implementation of the qualified mortgage (QM) definition and the qualified residential mortgage (QRM) standard, both required by the Dodd-Frank Act.

We believe that, as the market receives greater clarity on all of these regulatory issues, this clarity can facilitate an even greater investment in the private mortgage insurance industry.

As a public policy, it could been seen as self-defeating for the FHA to allocate precious dollars toward borrowers who would otherwise qualify for private mortgage insurance while other borrowers struggle to get financing. As a means of expanding mortgage availability to those less served segments of our country, the FHA has a critical role to play.

And this dynamic leads to my final point:

How FHA Premium Increases Can Have the Impact of Expanding Mortgage Availability

Higher FHA premiums can actually increase mortgage availability. Now this may sound inconsistent with policymakers' objectives, but in fact, we expect FHA premium increases to widen mortgage availability to less served communities.

As premium increases at the FHA take hold, the FHA will price itself out of the "prime" credit market that I mentioned earlier. Private mortgage insurers are willing to serve this prime market and, as the government backs away, investors are more willing to invest in the private industry.

In fact, we have started to see this play out, as I mentioned earlier. The FHA's market share of the insured mortgage space is down to 42% and decreasing while private mortgage insurance has seen its market share increase, and the average credit score among FHA borrowers is slowly declining.

Importantly, however, now that FHA capacity is not being allocated toward higher-credit-quality borrowers, the FHA's precious resources can be directed to qualified, but less creditworthy, households that have not had access to credit in recent years, hence widening mortgage availability.

Under this scenario, we see the FHA fulfilling an important policy objective of providing mortgage credit to underserved borrowers while private capital becomes increasingly available to meet growing mortgage market demand.

Again, I thank the Committee for inviting me today, and I am happy to answer any questions that you may have.

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