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House Financial Services Subcommittee on Housing and Insurance Hearing on
"Private Mortgage Insurance: Comparing Private Sector and Government-Subsidized Approaches"
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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.