STATEMENT OF KEVIN SCHNEIDER BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES
April 14, 2011

I am Kevin Schneider, President and Chief Executive Officer, U.S. Mortgage Insurance of Genworth Financial in Raleigh, North Carolina. I also am President of the Mortgage Insurance Companies of America (MICA), the trade association representing the mortgage insurance industry. I am pleased to be here today to discuss the risk retention provision of the Dodd – Frank Act. Since mortgage insurers' sole business is insuring mortgages with low down payments, I will confine my testimony to the definition of a Qualified Residential Mortgage (QRM) recently proposed by six regulators.

MICA is very concerned that the definition of QRM did not include loans with less than a twenty percent down payment that are privately insured and believes that these loans should be included in the QRM definition. We do not believe affordability and sustainability are mutually exclusive goals. Mortgage insurers enable home-ready borrowers to safely buy homes with less than a 20% down payment. We understand the drivers of sustainable, affordable homeownership because our industry has a vested interest in making certain that homebuyers are given mortgages they can afford to pay over the long term. If the loan is not sustainable, the capital of a mortgage insurance firm is at risk because it must pay a claim if the loan goes to foreclosure.

The proposed rule exempts loans sold to the GSEs from the risk retention requirements while they are in conservatorship because they carry an effective federal guarantee during this time. MICA realizes that many members of the subcommittee question that exemption and we understand their wish to both improve originations and minimize the role of the federal government. However, MICA supports that exemption because it maintains the status quo in the mortgage market until Congress deliberates over how to reform and revamp the secondary market as well as determine the future of FHA. Without that exemption the primary source of private sector capital in the market today – private mortgage insurance (MI) -- could be marginalized to the extent that it's no longer serving the market to its full capacity. As we discuss below this could impede the ability to return private sector capital to the market by driving virtually all low-down payment loans to FHA. Finally, maintaining the exception for GSE loans also insures that private mortgage insurance stands in front of the taxpayers if a low-down payment loan goes to default.

In this testimony, I will address the proposed definition as if the GSE exemption were not included. I will discuss the important role MI plays in the market and its regulatory structure. I will then discuss the reasons privately insured loans should be included in the QRM definition and be given parity with FHA-insured loans. The reasons include the following:

- Without the inclusion of privately insured loans in the QRM definition, credit-worthy, lower income and first-time homebuyers will have fewer or more expensive options to finance their home and could be locked out of the housing market altogether.

- Fewer options for prudent, low-down payment loans also will impede the housing recovery.
- To return private sector capital to the market, privately insured loans must be included in the QRM definition because risk retention requirements will drive low-down payment lending to the government programs that are exempt.
- Potential taxpayer liability for FHA-insured loans already is projected to reach more than $1 trillion and could climb further if privately insured loans are not put on an equal footing.
- Privately insured loans meet the requirements set for them in Dodd-Frank because private mortgage insurance reduces the risk of default.

The Role of MI

The primary barrier for most borrowers to buying a home is coming up with a 20% down payment. That barrier can be overcome in a safe and sound manner by encouraging the use of private mortgage insurance. MI enables borrowers to buy homes with less than a 20% down payment because MI takes the first loss after the borrower, if the borrower defaults. When the loan goes to foreclosure, the MI coverage typically pays the investor 20% to 25% of the loan amount.

Because mortgage insurers are in the first loss position on the mortgages we insure, our interests are aligned with those of both the borrower and the mortgage investor, thus ensuring better quality mortgages. Mortgage insurers act as a second set of eyes by reviewing the credit and collateral risks related to individual loans. This role protects both borrowers and investors by ensuring that the home is affordable at the time of purchase and throughout the years of homeownership.

The Regulatory Strength of MI

MI is a regulated, counter-cyclical source of loan level protection provided for a mortgage loan, based on independent, objective underwriting criteria. It is for this reason that global regulators have repeatedly reviewed and, then, confirmed the value of properly-regulated and appropriately capitalized private mortgage insurance. In January of 2010,[1] the Joint Forum urged member nations to ensure that greater use of MI is part of their mortgage-reform efforts. The Joint Forum is an advisory committee comprised of global banking, securities and insurance regulators. In addition to urging greater reliance on MI, the Joint Forum paper described the need to ensure that capital credit and regulatory recognition is provided only when private MI is in fact well regulated and capitalized, noting the significant problems that result from reliance on products such as credit derivatives.

[1] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations,* (Jan. 8, 2010), *available at* http://www.bis.org/publ/joint24.pdf.

The Joint Forum's advisory work has since been advanced as a firm recommendation from the Financial Stability Board[2] (FSB), the governing body for all global financial regulators (including those in the U.S.). In its final paper detailing recommendations for mortgage underwriting, the FSB concludes that, "Mortgage insurance can be relevant for the reduction of uncertainty through risk selection and pricing, a prudent application which includes an in-depth assessment of mortgage insurance reliability. The recent crisis has shown how deceptive risk transfer mechanisms can be."[3]

The backbone of the private mortgage insurance industry's financial strength is its state-imposed reserve requirements. The reserve requirements were developed in a model MI act that was established by the National Association of Insurance Commissioners (NAIC) and is primarily enforced by the states where MI companies are domiciled. The requirements are specifically structured to address the long-term nature of MI risk. They enable the industry 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 normally throughout the cycle.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Fifty cents of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times not only to handle claims under stress, but also to avoid boom-bust cycles. The contingency reserves are directly comparable to the counter-cyclical capital bank regulators now know they need. Mortgage insurers are subject to similar mortgage default risk as banks but only mortgage insurers raise capital counter-cyclically.

Chart 1 demonstrates how the MI industry builds its capital base during good times to pay claims in bad times like those currently experienced by the housing market. The chart shows yearly industry losses paid as a percentage of premiums earned for each year from 1980 through the third quarter of 2010. It also shows the MI industry's risk to capital ratio for each year and the build-up of premiums available to pay claims over time. As can readily be seen, the fact that mortgage insurers do not earn all of the premiums they receive each year -- but are required to keep a portion of the premiums in a contingency reserve -- means that premiums available to pay claims increase during the good times so they can be paid out to cover the serious losses that occur during the bad times.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults. Premiums received for the term of a policy are placed in unearned premium reserves. Each state establishes the method by which premiums are earned to match premiums with loss and exposure.

[2] Financial Stability Board, *Thematic Review on Mortgage Underwriting and Origination Practices* (Mar. 17, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110318a.pdf.
[3] Ibid, p. 25.

The history of the MI industry shows that we have paid our 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 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.

The first loss position of MI makes it a valuable offset to mortgage credit risk. This benefit extends to lenders that hold loans in portfolio and in the case of Fannie Mae and Freddie Mac, to taxpayers who are otherwise exposed to GSE losses. Over the course of the current mortgage crisis, the MI industry estimates that it will pay around $30 billion in claims in front of the taxpayer to Fannie Mae and Freddie Mac. Indeed, since the current mortgage crisis began, Fannie Mae and Freddie Mac have received from mortgage insurers $22 billion in claim payments and receivables, equivalent to more than 14% of the amount U.S. taxpayers have had to spend to date on the GSEs during their conservatorship.

Not only does the MI industry have ample regulatory capital with the three types of reserves discussed above, but it also has been able to attract new capital to the industry. Since the mortgage crisis began, the industry has raised $8.8 billion through new capital and assets sales and investors have provided an additional $600 million to capitalize a new entrant to the industry. The recent capital inflows to the industry are strong indicators of investor confidence in the private mortgage insurance business model and regulatory construct.

It is not surprising that the credit risk mitigation tools that were often used prior to the crisis are no longer available. The capital and regulatory strength of the MI industry as well as its proven ability to withstand periods of heavy defaults, is in sharp contrast to other forms of external loan-level credit enhancements which are not regulated, not well capitalized, and have not demonstrated a capacity to satisfy their obligations and ensure prudent loan originations. In addition, many are not offered by a bona fide, third-party unrelated to the originator or securitizer. For example, credit default swaps (CDS) have been a source of profound systemic risk in the current crisis, and the regulatory framework required to correct this problem still must be constructed following the new standards in the Dodd-Frank Act. The Joint Forum paper cited above details an array of supervisory and capital problems in the CDS sector that have yet to be acted upon and reformed in the U.S. or global markets.

Inclusion of MI in QRM is Essential for Credit-Worthy Homebuyers and the Housing Recovery

Since 1957, the private mortgage insurance industry has helped more than 25 million families buy homes. The MI industry's insurance-in-force as of December 31, 2010 was $753 billion, or 7.1 percent of U.S. single family, first liens then outstanding. Since 2007, mortgage insurers have paid over $22 billion in claims.

Credit-Worthy Homebuyers Need Options

According to the 2009 Home Mortgage Disclosure Act (HMDA) data (the most recent data available), 37% of the borrowers who received mortgages insured by private mortgage insurers to purchase homes made less than area median income and 23% made less than 80% of area median income. We believe the primary users of MI to purchase homes are first-time homebuyers. This sector is crucial to the reduction in excess housing inventory which is essential to a full recovery in the housing market. A survey by the National Association of Realtors estimates that half of all purchases last year were by first-time homebuyers and that 86% of these buyers made down payments below 20%.

Without broad availability of affordable low-down payment loans, hard-working Americans will have to wait significantly longer before they are able to save enough to purchase their first home. For example, at a typical savings rate, it would take a family earning $50,000 a year, more than eleven years to save a 20% down payment on a $153,000 home (the median priced existing house sold in the U.S. in 2010).

QRM Should Not Impede the Housing Recovery

Today, wide availability of low-down payment loans also is necessary for the housing market recovery. As a result of the current housing downturn many families that bought during the market boom have lost equity in their current homes. People who bought homes in the past few years but now need to move for a new job or need a larger home for their family are at a disadvantage with a 20% minimum down payment requirement because they were not able to build equity as homeowners did in past years and may well have lost some or all of the equity they invested in their current home. These low down payment repeat and first-time homebuyers who need private, low-down payment options are a large part of today's housing market and are critical to a housing recovery. The National Association of Realtors estimates that 75% of all buyers – first-time buyers and repeat buyers – financed 80% or more of their home purchase in 2010.

Without the continued availability of adequate, prudent private capital options for low-down payment lending, both first-time and repeat homebuyers will have fewer attractive financing options. As a result, these potential home purchasers will delay or end their attempt to buy a house and, as a consequence, impede the housing market recovery.

Private Sector Capital Ready to Make Prudently Underwritten Mortgages Affordable

Today the MI industry is well positioned to help expand affordable housing opportunities in a responsible manner. However, including MI-insured loans in the QRM is essential to enabling the industry to put its private capital to work. Under strong capital rules from state insurance regulators, the MI industry has sufficient capital to increase their total insurance exposure by $261 billion a year for the next three calendar years. If this additional volume is realized it would mean that approximately 1.3 million additional mortgages would be insured in each of the next three years. Many of these new insured mortgages would go to lower income and first-time homebuyers who do not have the necessary funds to make large down payments but still have adequate income and credit to enjoy long-term, sustainable homeownership through an insured mortgage.

Without MI Loans Included in QRM, Low-Down payment Lending will be Pushed to FHA

Requiring a 20% minimum down payment for all loans, unless they are insured by a federal agency such as the FHA, will seriously undermine efforts to bring private sector capital back into the housing market and may expose taxpayers to significant new risk. It is clear that regulators intend risk retention to be expensive and they have succeeded for bank securitizers. For bank mortgage securitizers, the proposed risk-retention requirements will be very costly. Both the current capital requirements[1] and Basel III,[2] impose significant risk-based capital requirements for the three options in the proposal. In fact, these requirements make the risk-retention position among the most capital-intensive positions for banks under both the current and new regulatory capital standards.

The added capital pressure of the risk retention rule will only exacerbate reductions in credit availability, which we believe could essentially shut down mortgage origination and securitization outside the QRM exception. Of course, the other alternative is to originate FHA-insured loans because they are completely exempt from the risk retention requirements and impose no extra cost on securitizers. As a result, if privately insured loans are not treated similarly to FHA-insured loans, lenders will direct homebuyers who cannot accumulate a 20% down payment to FHA.

Beyond the cost of risk retention, FHA offers 100% government insurance. In contrast, as noted earlier, private mortgage insurers generally cover 20% to 25% of the loan amount. In today's housing market with falling or stagnant home prices, this feature of privately insured loans generally means that lenders do have "skin in the game" because lenders often suffer a loss even after they receive the MI claim payment and the proceeds from the sale of the house.

FHA already is exposing taxpayers to significant potential liability. The fiscal year 2012 Administration budget projects that the FHA's insurance-in-force will increase 28% in this fiscal year (2011) and 10% in the next fiscal year. Taxpayer exposure for FHA mortgages will be $1.253 trillion by September 30, 2012. Not treating privately insured loans similarly to FHA-insured loans in the QRM could significantly increase that potential exposure.

<u>Mortgage Insurance Meets the QRM Standard – It Reduces Defaults</u>

<u>MI's Incentive to Reduce Defaults</u>

Section 941 of the Dodd-Frank Act recognized that risk retention can be a strong deterrent to excessive risk taking that led to the housing crisis. At the same time Dodd-Frank

[1] 12 C.F.R. § 3, Apps. A and C.

[2] Basel Committee on Banking Supervision (BCBS), *Basel III: A Global Regulatory Framework For More Resilient Banks And Banking Systems* (Dec. 16, 2010) *available at* http://www.bis.org/publ/bcbs189.htm.

acknowledged that risk retention should not apply to all mortgage loans because doing so would add unnecessary costs to loans and reduce liquidity. As a result it directed six agencies to jointly develop a definition of a QRM and gave them criteria to consider. One of those criteria was private mortgage insurance to the extent that it reduces defaults.

Private mortgage insurance meets that condition because, as noted above, it brings a second set of eyes to the mortgage origination process. It acts as a review underwriter of the risk factors in the mortgage application and makes an independent judgment as to whether the borrower can afford the home. Mortgage insurers have their own capital at risk, in the first loss position and, therefore, work up-front to ensure the borrower can afford the mortgage.

Having our own capital at risk also means that mortgage insurers have very clear incentives to mitigate their losses if loans are in default. The best way to do that, of course, is to avoid foreclosures altogether by working with borrowers to keep them in their homes. Mortgage insurers have a history of partnering with lenders, investors and community groups to work with borrowers in default. This often means that, with the servicers' permission, mortgage insurers counsel the borrowers personally and determine if their financial problems can be resolved. From 2008 through year-end 2010 mortgage insurers have completed almost 645,000 workouts covering $130 billion in mortgage loans.

Data Proves MI Reduces Defaults

Recent analysis of MI-insured mortgages versus piggyback mortgages brings to light the importance of private sector capital at risk in a first loss position.[4] Piggyback loans are loans where borrowers have little or no equity in their mortgages. Instead, borrowers get an 80% first mortgage loan and simultaneously get up to a 20% second mortgage. Therefore, the borrowers have little or no equity in their mortgage, but unlike low-down payment loans with private mortgage insurance, there is no private sector capital at risk in a first loss position.

An analysis using loan level data on 4.9 million loans originated between 2003 and 2007 compared delinquency, default and cure rates of loans with combined loan to value ratios (CLTV) of over 80% that were done as single first liens with mortgage insurance to over 80% CLTV loans that were structured as piggyback mortgages with an uninsured first lien coupled with a simultaneous second lien mortgage. Piggyback loans became delinquent or defaulted approximately 1.65 times more frequently than insured loans with the same characteristics including, CLTV, borrower credit scores, origination year, geographic location, loan purpose and borrower documentation levels. This analysis demonstrates that not all low down payment loans are the same. MI significantly mitigates the risk that a high LTV loan will become delinquent and go to default. The data makes it clear that with proper underwriting and mortgage insurance, low down payment lending can be done without exposing the borrower, lender or investor to excessive risk. A chart with a summary of the data is the first attachment.

[4] http://sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-6.pdf

MIs Raised Concerns Before the Mortgage Crisis and Will Continue to be a Vital Watchdog.

Because of its unique position in the market, the MI industry was the "canary in the coal mine" for the problems in the mortgage finance system long before the bank regulators and the rest of the industry recognized what was happening. The industry can and should continue to perform that function and, therefore, should be included in the QRM definition.

Beginning in 2002 the MI industry raised concerns with financial institution regulators about the underwriting of high-risk mortgage products and the regulatory and capital incentives that existed for the creation of these products. The industry's concern was derived from the economic interests of the industry, its position as the provider of first loss protection on first lien, residential mortgages and the industry's half century of experience in reviewing mortgage underwriting by lenders during good and bad economic times. The industry's initial concern was focused on the growing number of structured finance, or piggyback loans in the market that not only were higher risk loans because the borrower had little or no equity in the property, but – importantly – because there was no private sector capital at risk when the lenders avoided MI by using a piggyback structure.

MICA began to communicate with bank regulators on the problems the industry was seeing in the market in 2002. As MICA explained in a December 3, 2002 letter to the Federal Reserve, OCC, OTS and FDIC referring to the use of piggyback structures:

> MICA would remind the agencies that mortgages are a major source of risk to insured depositories. Despite the high quality of the collateral underlying first liens on residential mortgages, these loans were the underlying source of the S&L debacle during the 1980s because thrifts did not hold sufficient regulatory capital against the various risks these assets pose. Mortgages have since become still more risky because of the increasing role of high-LTV mortgages, at the same time that consumer debt-service burdens have reached unprecedented levels despite historic low interest rates. A failure to impose appropriate regulatory capital for the riskiest type of mortgage asset – structured seconds – could expose the nation's financial system to significant risk as interest rates rise, housing markets weaken and consumers struggle to honor their obligations.[5]

Because of the MI industry's unique position we had good reason to be concerned with what was developing in the mortgage market even though these loans were generally done in a piggyback structure. Our fear – which proved to be valid – was that these practices would poison the well. As we noted in a September 23, 2005 letter to the bank regulators:

> Our concern is based in part on the fact that high-risk products can undermine reliance on proven forms of credit risk mitigation like private mortgage insurance (MI). But, far more disturbing to us is the fact that recent trends could lead to sudden increases in

[5] Letter dated December 3, 2002 from MICA to Hon. Susan Bies, Hon. James E. Gilleran, Hon. John D. Hawke, Jr., and the Hon. Donald E. Powell.

> foreclosures, accompanying sharp reductions in the value of residential mortgage collateral. This would, in effect, “pollute the residential mortgage well” – a well of profound importance to the depository institutions you regulate and to the mortgage insurance industry.[6]

Looking back it should not be a surprise that the MI industry was one of the first mortgage market participants to see the rapid deterioration in mortgage underwriting standards that was occurring and the dangers of piggyback mortgages. The MI industry by virtue of its private capital in the first loss position, its role as a reviewer of the underwriting of the loan, its counter-cyclical regulatory capital requirements and its long term view of housing market cycles had in the early 2000s and continues to have today a vested interest in a mortgage market that gives all parties incentives to put homeowners in mortgages that they can afford to pay over the long term. It is essential for the future health of the mortgage market that there remains private sector capital in this unique position.

It is important that mortgage insurers not be cut out of performing this vital function by not having loans they insure included in the QRM because no other entity is in the mortgage insurers’ unique position. While under Dodd-Frank, FHA still will be able to insure low-down payment loans; FHA cannot perform the “canary in the coal mine” function because only government money is at risk, not private sector capital. In addition, FHA does not have the sophisticated analytical tools as do private mortgage insurers. Similarly, the bank regulators do not have the ability to move swiftly with market changes. They have the authority to promulgate regulations but this a cumbersome process. Note that the non-traditional mortgage guidance that was finalized in 2006 took four years to be completed with the regulators finally issuing a weak version of their initial proposal only after being called to account at a Senate Banking Committee hearing demanding action on the long-stalled standards. And, even when regulators began to act on the non-traditional mortgage guidance as the scope of the crisis became apparent, the only tool the agencies had at hand was a “guidance,” not binding rules. As a result, many institutions disregarded regulatory injunctions to change mortgage lending practices despite the growing mortgage crisis.

Conclusion

In summary, it is essential that privately insured loans be put on an equal footing with FHA-insured loans in the final version of the QRM. The private mortgage insurance model has withstood the test of time. We have helped house America for more than 50 years. We have been there through the tough times of the regional recessions of the 1980's and 1990's and of course through this recent national housing crisis. We will continue to work closely with borrowers, servicers and others to help people stay in their homes. Finally, we stand ready to play a critical role in the future of housing finance by safely and soundly enabling first-time and lower income families purchase homes.

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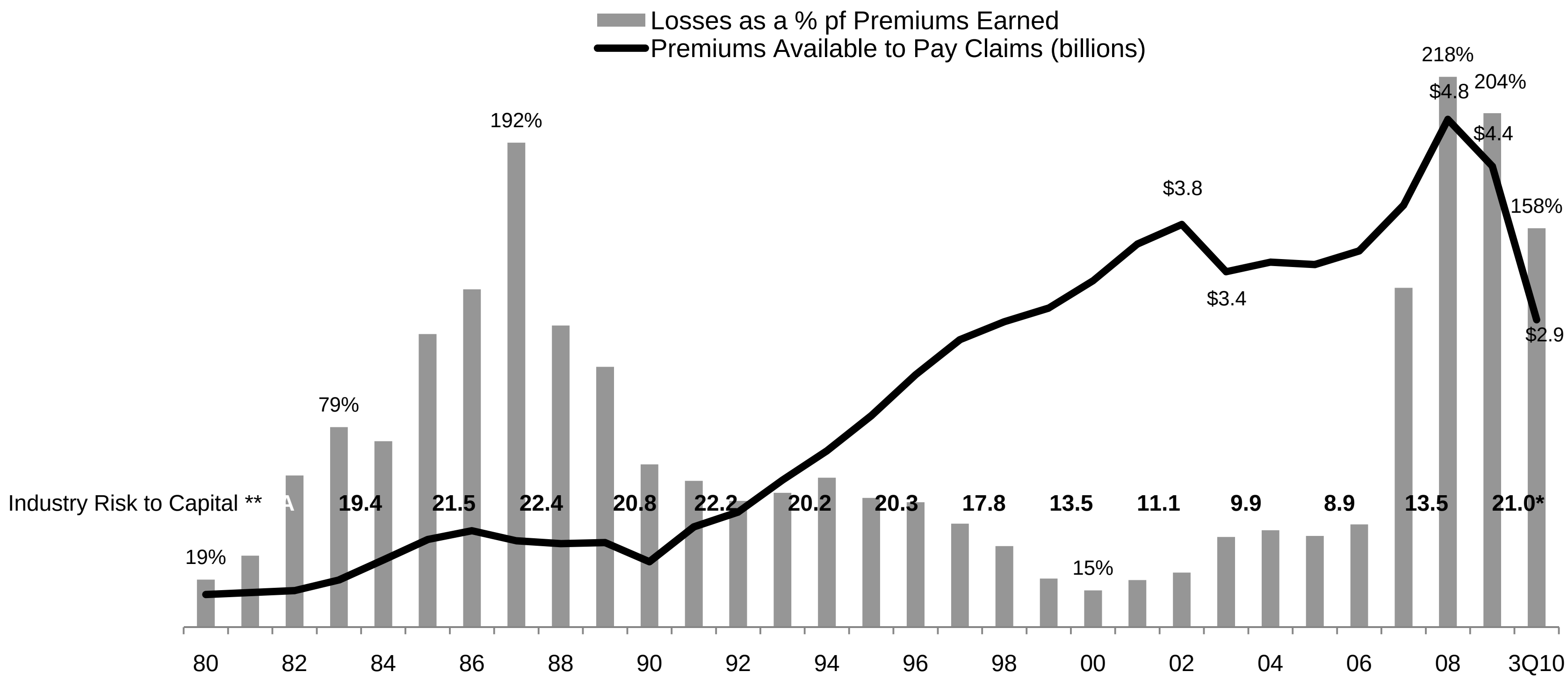
[6] Letter dated September 23, 2005 from MICA to Hon. Susan Bies, Hon. John Dugan, Hon. Donald Powell and the Hon. John M. Reich.

Chart 1

MIs Build Capital in Good Times to Pay Claims in Bad Times



Source: MICA Reports & Statutory Filings

- **Mortgage insurance is priced for long-term cycles.**
- **New business in recovery phase rebuilds capital base and replenishes contingency reserves.**

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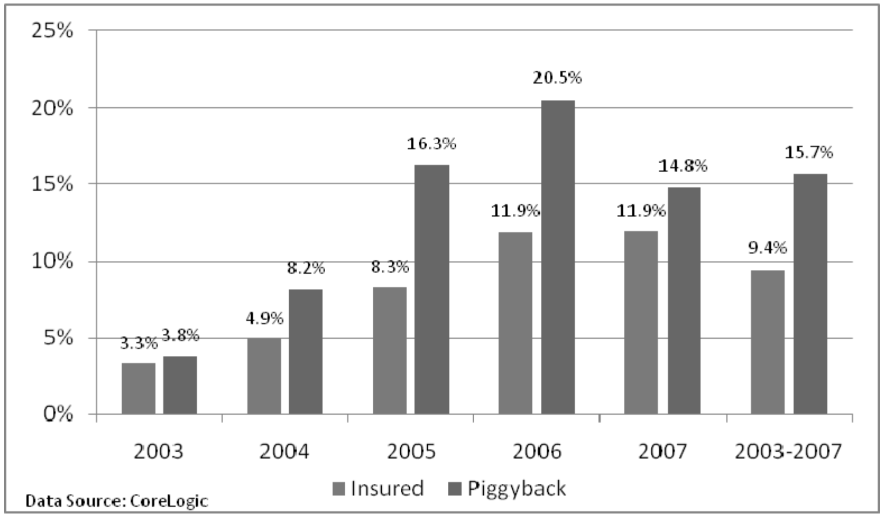
*2009 and 2010 Includes new entrant capital (Essent Guarantee)

**Dollar Amount of Industry Net Risk on Insured Mortgages Divided By Industry Regulatory Capital

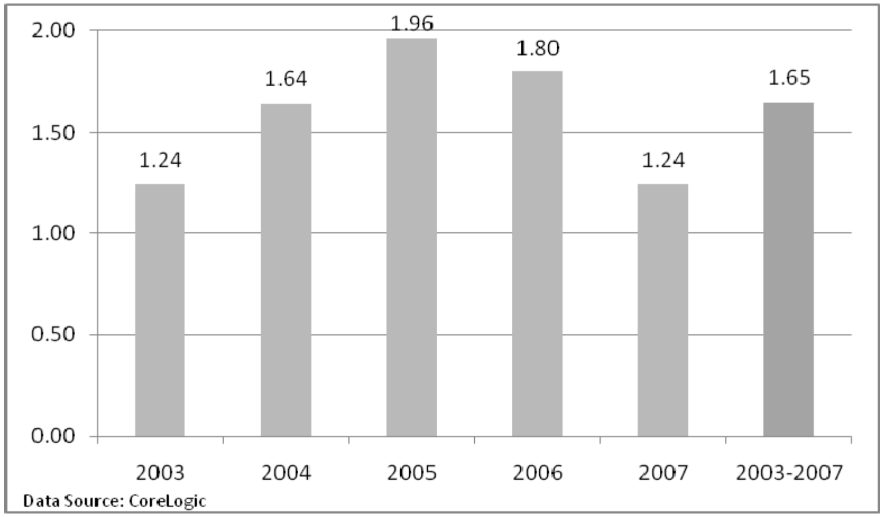
Chart 2
Piggybacks Versus Insured Loans

- **Performance of Insured loans with combined loan to value ratios above 80% (High CLTV) Compared to High CLTV Piggyback loans (uninsured 1st liens with simultaneous 2nd liens)**
  - **CoreLogic Servicing Database**
  - **Origination years 2004 – 2007**
  - **Total # Loans = 4.9 million (1.1mm Piggyback; 3.8mm Insured)**
  - **Performance data for each normalized to the FICO & LTV distribution of the total population**
  - **Compared Percentage of Non-Performing Piggyback loans to Non-Performing Insured Loans by Origination Year, FICO group, CLTV and Geography**

Non Performing Rates By Origination Year
(Currently 90+ Days Delinquent & Defaults)



Ratios Of Piggyback Non-Performing Rates To Insured
(Piggyback Non-Performing / Insured Non-Performing Rate)



End Result … Insured Low Downpayment Loans Have Lower Risk of Default than Comparable Piggyback Loans

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Kevin D. Schneider	Mortgage Insurance Companies of America

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.