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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

[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

[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

[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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