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

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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 <u>private capital</u> 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 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. 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.