Essent
Essent Guaranty, Inc.

STATEMENT OF ADOLFO MARZOL

VICE CHAIRMAN

ESSENT GUARANTY, INC.

SUBMITTED TO THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 29, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to participate in this important hearing.

I am Adolfo Marzol, Vice Chairman of Essent Guaranty, Inc. ("Essent"), a new, nationally licensed private mortgage insurance company headquartered in Radnor, PA. I am pleased to be able to present Essent's views regarding reform of the single-family secondary mortgage market. Let me begin by stating that the historical configuration of the secondary mortgage market has provided vital liquidity and stability to both single-family and multifamily lending and questions of reform must address both. Our comments today are directed to single-family reform, the market we serve. The reform solutions necessary for the single-family market, which is residential lending, are likely to be different from those that may be required for the multifamily market, which is commercial lending. We urge policy makers to consider each market separately and develop appropriate, tailored solutions for each market.

Our proposed approach to reform is consistent in some ways with other reform proposals that have been discussed publicly. However, with regards to the most fundamental questions – what role should government play versus private enterprise in a reformed system and how should those roles be organized – our views differ in important ways. We hope that our views provide added insights regarding important public policy choices and that they will be given consideration.

Concepts Shared with Other Proposals

Our proposal for reform is consistent with many others in three critical ways:

1. The U.S. federal government should provide a full faith and credit guarantee of mortgage backed securities to enable the U.S. mortgage market to attract global liquidity and preserve the 30-year fixed rate mortgage. We, like many others, believe the U.S. should **not** adopt a housing finance system built primarily around adjustable rate or balloon mortgage loans that require average homeowners to manage interest rate risk and deal with mortgage payment shocks. Homeowners are the least able in the system to manage these risks. Without the presence of the federal guarantee, we doubt that risk-averse global investors will be willing to invest in long term fixed-rate mortgage instruments in amounts sufficient to support a mortgage market of the size that the U.S. requires.

2. Government should bear only a discrete and remote credit risk in a new, reformed system. Private capital should bear expected credit losses and the losses that can result from serious macroeconomic adversity resulting in large, nationwide home price declines. Private capital should be sufficient in amount to withstand such losses, trapped and targeted to the absorption of losses and strengthened in favorable parts of the economic cycle by a countercyclical capital accumulation framework. The government's guarantee should only be called upon in the most extreme and limited of circumstances. Further, this guarantee should be on specific securities, not on the entities that create them. A smaller, and more targeted role for government in the mortgage market would be in marked contrast to today's mortgage market for new loans, where virtually all the credit risk is being borne by taxpayers through the FHA, the VA, the GSEs or other government mortgage financing programs.

3. The government guarantee should be financed in advance through fees charged on mortgage securitizations that receive the guarantee. This approach corrects one clear defect of implied guarantees, which by their nature cannot be financed in advance. In addition to building reserves for covering a remote risk of loss, an incremental fee should be collected to fund proper administration of this new securitization program so it is self-financing. Finally, we propose this new guarantee program include an explicit fee to fund affordable housing programs. Supporting affordable housing through fees that can reduce mortgage costs for financially disadvantaged but credit-worthy borrowers, or to assist rental housing, is preferable to mandates such as housing goals, that can distort underwriting discipline.

The time has come for the policy process to find a practical and achievable path forward that delivers to the U.S. homebuyer an affordable, 30-year fixed rate mortgage, but limits the role of government and exposure to taxpayers. This will require a larger and more central role for real private enterprise providing dedicated and adequate capital to take and manage mortgage credit risk.

Where We Differ from Other Proposals

Instead of starting with the current GSE model as a basis for change, our approach builds on the successful structure of the Government National Mortgage Association ("Ginnie Mae") securitization program. Since the 1960s, this program has provided the capital markets with a full-faith and credit mortgage security, and has done so without portfolios or "hybrid" structures faced with conflicting mandates. This model is currently serving about 25% of new U.S. mortgage originations. This guarantee permits investors around the globe who invest in these mortgage securities to focus on managing interest rate and prepayment risk rather than credit risk. In this program, FHA (which also enjoys the full faith and credit backing of the United States), writes mortgage insurance that takes the vast majority of the credit losses when mortgages default. Lenders must underwrite and service mortgages in accordance with the requirements of FHA in order to obtain their mortgage insurance, and borrowers must pay the FHA insurance premiums. Ginnie Mae provides the security guarantee when the loans are insured by FHA and other Ginnie Mae requirements are met. Ginnie Mae collects a fee for the guarantee, in addition to the fees charged by FHA.

In the Ginnie Mae/FHA secondary market model there are no GSEs and there are no investment portfolios of mortgage assets. There is only a clear and simple set of roles and responsibilities that enables this large sector of the mortgage market to function – a security guarantee that benefits investors and mortgage insurance that takes mortgage loan credit losses.

We believe that this precise framework can be replicated for the broader single-family mortgage market, albeit with one small but essential change: providing a government guaranteed securitization option in which the credit risk of each mortgage is borne by one of a group of fully private, adequately capitalized, competing private mortgage insurance companies that would insure the full risk of credit loss. This approach would not displace the role of FHA in providing mortgage insurance in those situations that Congress deems appropriate for full taxpayer risk. Rather, this proposal adds to the existing FHA "public option" a parallel "private option" for bearing the credit risk. This "private option" means having well-capitalized private mortgage insurance, rather than government-backed mortgage insurance, bearing the credit risk for those borrowers not appropriate for FHA insurance. An expanded role for private mortgage insurance can be met by a combination of the existing industry raising new capital and the entry of new competitors. This approach preserves FHA for a properly targeted role of subsidizing affordability for borrowers where private financing may not be offered or where the costs of private financing are deemed too high by Congress.

Public Benefits Achievable Through Our Proposal

Essent's approach to reform can produce attractive public policy outcomes that should be given bipartisan consideration. These include:

1. Preserving an affordable and accessible 30-year fixed rate mortgage in a highly liquid mortgage market that can attract global investment capital.
2. Bringing private capital and private enterprise back into the housing finance system to price, manage and bear credit risk, creating a path to an appropriately smaller credit risk

bearing role for government - limited to the risks of the most extreme and unlikely economic outcomes or those taken on behalf of borrowers where full taxpayer risk bearing is deemed appropriate to achieve societal goals.

3. Reforming the system without creating new "hybrid entities," which we define to be entities that mix private profit objectives with social goals and mandates. The creation of new hybrids creates significant risks of new implicit guarantees and entities that become "too big to fail."
4. Avoiding very substantial transition risks in an already weak housing market by using existing mortgage market capabilities and putting them together in a more logical way for new mortgage securities.
5. Allowing for an orderly wind-down of the GSE legacy portfolios and continued support for troubled borrowers through the existing GSE and FHA modification and refinance programs.
6. Funding affordable housing with explicitly allocated cash flows that can reduce costs to lower income borrowers and renters, while avoiding the distortions of underwriting discipline that mandates such as housing goals can encourage.
7. Maintaining a system that allows small community banks and mortgage bankers to compete, because they will not need large volumes or large capital bases to access this system (*n.b.*, a Ginnie Mae "pool" today can be created from a single loan).

While these outcomes may not be the perfect answer for any single policy maker or industry participant, we believe the overall result of adopting our proposal will best serve our citizens – both as homeowners and as taxpayers.

Concerns Regarding Reform Proposals that Create New "Hybrids"

When evaluating reform alternatives, we urge policy makers to be aware of the risks inherent in creating new "hybrid" entities at the center of the mortgage securitization process. Reform proposals risk creating new hybrids, rather than real private enterprises, when they include characteristics such as: (1) mortgage portfolios held to earn a spread, (2) mandates that will need to be funded by lower returns, (3) excess leverage or special benefits, or (4) special or limited numbers of charters.

Even if the government does not guarantee these entities, new hybrids will eventually be viewed as implicitly guaranteed and can become "too big to fail" by virtue of having been given a special and central role in housing finance. Further, any wholly new entities with central roles for mortgage securitization would require years to become operational from a *de novo* start unless these entities are simply a reconstituting of the two existing GSEs, with minor modifications. If past conflicts of interest are to be eliminated from the mortgage finance system, then reforms must be faithful to the concept of "no hybrids" and committed to changes that are organized around real, private market entities competing to bear credit risk with strong capital and sound risk management without special burdens or benefits.

The existing GSEs should be allowed to focus on the orderly management and runoff of their existing legacy assets, and continuing to work with troubled borrowers. Fire sales of assets and disorderly transitions regarding the GSEs can be avoided. To the maximum extent possible, the skilled people, operating abilities and specialized systems of the GSEs should be utilized to support the securitization process for a reformed market, not as risk takers, but as processors, much as Master Card and Visa serve the credit card markets without portfolios or bearing of credit or interest rate risk.

Rationale for Role of Private Capital

We realize that our proposal requires rethinking some firmly entrenched presumptions regarding the housing finance system. Many find it difficult to visualize a new housing finance system without multifunction GSEs (*e.g.*, mortgage portfolio holder, mortgage insurer, securitizer, affordable housing subsidy provider) at the center of the system. Our approach breaks these distinct functions into logical components that require clarity as to roles - none more important than drawing a bright line between the role of private enterprise and the role of government.

Importantly, our approach requires recognition that private mortgage insurance is not limited to bearing credit risk for low down payment borrowers. Yes, for over 50 years private mortgage insurance has helped low down payment borrowers achieve home ownership by insuring lenders and investors from credit losses when these borrowers default. We are proud of supporting low down payment borrowers and our industry can continue to serve this vital market segment regardless of the structure of secondary market reform. But, our industry doesn't exist solely for bearing credit risk on low down payment borrowers and has provided mortgage investors protection on mortgage loans with larger down payments when investors have sought such protection.

Private mortgage insurance is an insurance contract that pays benefits to mortgage lenders or investors for insured mortgage loans that default regardless of the percentage of down payment. Private mortgage insurance companies - there are 8 currently active - deploy private capital to take mortgage credit risk and pay claims from their revenues and capital. In Canada, where the housing finance system has been credited with unique stability through the recent crisis, private mortgage insurance insures 100% of the risk of credit loss on insured loans, in contrast to the U.S. tradition of partial insurance coverage – generally 25% of the loan amount.

Some outside the mortgage finance industry may not appreciate the role that private mortgage insurance plays in enabling homeownership, or the degree to which private mortgage insurance has served to protect the taxpayer during the crisis. Perhaps unique among industry segments heavily exposed to mortgage credit risk, private mortgage insurance companies have survived the mortgage crisis without a taxpayer bailout. In fact, rather than receive taxpayer funds, private mortgage insurance will actually dramatically lessen the taxpayer's burden from the mortgage crisis. As our housing market struggles to recover from the crisis, private mortgage insurance companies are estimated to pay out $35-50 billion in claims, all from private capital. The largest recipients of private mortgage insurance payments have been the taxpayers, through the conservatorship of Fannie Mae and Freddie Mac who are the largest beneficiaries of the private mortgage insurance industry. Importantly, our industry has raised additional private capital since the crisis began, increasing the capacity to pay claims and write new insurance to support the nascent housing recovery.

The performance of the private mortgage insurance industry is an example of countercyclical and trapped private capital doing the job that was intended from a strong capital framework for bearing risk. This strong capital regime was put in place from the lessons learned in prior housing and mortgage crisis, when state regulators implemented reforms which led to the modern structure of the private mortgage insurance industry. Our industry is an example of competitive private enterprises without special Federal charters, none "too big to fail," relying on private capital - not taxpayers - to take credit losses and weather an extraordinary economic crisis. Individual companies within our industry were challenged and substantial losses were suffered, but without posing a systemic risk to the housing finance system or the broader economy.

We do not suggest that our industry does not have lessons to learn from this crisis, as it has from prior episodes of economic and housing stress. One firm went into "run-off" and some strained to write new insurance as capital was depleted by credit losses. Constructive action by state regulators, the GSEs and FHFA contributed to the ability of the private mortgage insurance industry to weather the crisis. Insureds and policy beneficiaries would also benefit from greater clarity and consistency regarding the contractual enforcement of loan origination representations and warranties, which is a broad issue in the mortgage industry and not one confined to mortgage insurance. But, few industries engaged in mortgage risk management through this crisis could have come through the crisis with no issues or questions, but we believe the fundamental value proposition of mortgage insurance was reaffirmed through the crisis.

Essent recognizes that the industry can be made an even safer and more reliable segment of the housing finance system, and that reforms will be necessary to implement our proposal. But, we believe the necessary changes are eminently achievable and, working constructively with policy makers and regulators, we would provide leadership to achieve them.

We also do not propose an exclusive role for private mortgage insurance as the sole entities to provide the necessary credit risk bearing in a reformed system. While other approaches to private credit risk bearing should be assessed, there are a number of policy considerations that should be applied to potential risk bearing alternatives. First, because the private mortgage insurance industry is in place today, reform efforts in the direction we have proposed can be implemented much more quickly than most alternatives. Second, alternative risk bearing approaches should enhance competition, but without sacrifice to adequate, trapped and countercyclical capital and sound regulation. Third, alternative forms of risk bearing should avoid issues of concentrations of risk that would reinforce "too big to fail" concerns already inherent in the system. Finally, alternative forms of risk bearing should preserve ready access by small community banks and mortgage bankers, allowing smaller entities to compete and effectively serve their markets with competitive 30-year fixed rate mortgage loans.

Private mortgage insurance is here now and ready to serve. By using the existing private mortgage insurance industry, and likely other new entrants to our industry, a new housing finance system can be put in place more quickly, rather than continuing to increase the amount of business being done by a system that is bankrupt due to a lack of adequate capital and the conflicts inherent in "hybrids."

Economics of Reform

Essent has completed a preliminary quantitative analysis to assess the level of private capital necessary to withstand all but catastrophic economic conditions and to measure the mortgage interest rate impacts resulting from a system structured as we propose. Essent would be pleased to share further details of our analysis upon request. This analysis concludes that:

1. If the new private system has claims paying resources of between 4 and 5% of mortgage balances originated by the new system, the government will be protected from credit losses in all but the most extreme economic downturns.
2. Mortgage costs to borrowers on new loans will rise only modestly from those of a GSE-based system of mortgage finance, less than a 3/8% estimated total cost increase. The increase primarily reflects the undercapitalization of the GSE system and the collection of fees by the government that were not collected for the implicit guarantee provided the GSE system.
3. The program could produce substantial revenues to the government for loss reserves in the event of a future severe home price decline resulting in the unlikely call on the government guarantee, funding for affordable housing and revenues to finance strong program administration.

Credit risk is not free, as this housing and mortgage crisis has so painfully reminded us all. Credit risk has to be supported by appropriate capital and adequate pricing up front or these costs will be extracted afterwards by the market in lost value for homeowners, investors or taxpayers alike. Now is the time to begin the process of transitioning to a new and more sustainable system of housing finance.

Conclusion

We have presented a new approach to reform the single-family secondary mortgage market. An affordable and widely available 30-year fixed rate mortgage can be preserved while establishing clearly separate roles and responsibilities between private enterprise and government. Increasing the role of private enterprise while reducing the role of government – without abandoning affordable housing – is the right direction for the future. These results can be achieved without creating new hybrids that will come to be viewed as implicitly guaranteed and "too big to fail."

We recognize that there are many details that need to be resolved and that transition issues will loom large for a housing finance system of the size and complexity of the U.S. mortgage market. However, the transition issues are manageable if the long term vision is clear and correct and an appropriate regulatory structure is in place. Transition issues should, appropriately, affect the pace of change to allow time for private enterprise and private capital to build its capacity and step into the risk bearing role government is currently playing. Essent has previously suggested that private capital backed risk sharing could be increased now, within the existing GSE system, as an important transition step in the right direction. But, transition issues should not deter the building of a new secondary mortgage market on a sound and principled foundation that will serve our nation well for decades to come.