STATEMENT OF PATRICK SINKS ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE
December 1, 2011

I am Patrick Sinks, President and COO of Mortgage Guaranty Insurance Corporation, testifying on behalf of the Mortgage Insurance Companies of America (MICA), the trade association representing the private mortgage insurance industry. I am pleased to be here today to take a comprehensive look at the financial situation of the Federal Housing Administration (FHA) and to offer suggestions on ways to improve its financial security and overall operation.

The mortgage insurance (MI) industry is similarly situated to FHA in that we insure loans with less than a 20% down payment, so we are particularly well suited to help Congress determine the best way to maintain FHA's viability. Importantly, MICA has been analyzing and commenting on the financial health of FHA for over 20 years. MICA advocated for and supported the financial reforms to FHA that were enacted in the National Affordable Housing Act of 1990 when most other sectors of the mortgage market did not. That Act was passed because FHA was in unprecedented stress at the time and policy makers feared taxpayers would be forced to bailout FHA. In fact it was that Act that, for the first time, required FHA to maintain a minimum capital ratio, which was set at 2%. It was also that Act that mandated the yearly actuarial report that is the subject of this hearing today. It would appear as if we are at a similar crossroad today as FHA's capital ratio is getting perilously close to being in the negative.

The private mortgage insurance industry believes the FHA has an important role to play in the mortgage markets as a supplement to private capital sources. While both entities provide first loss credit risk protection on low down payment mortgages, FHA is a government program while MI is private capital put at risk. For over fifty years the private mortgage insurance industry has supplied credit enhancement to borrowers seeking their first home at the same time as the FHA has provided its credit enhancement to other first-time borrowers.

While there has always been some overlap between the customers served by private mortgage insurers and FHA, we believe that it is important that there be both private capital made available through mortgage insurers for low down payment borrowers as well as government-backed capital made available through FHA for those borrowers who, because of income, credit or other characteristics require the additional support that only a government guarantee provides. We believe that both entities have knowledge and strengths that can be employed separately and, perhaps, together to serve first time homebuyers. FHA, as a government program, must not be employed either intentionally or unintentionally as a means of blocking the re-entry of private capital to the mortgage markets.

The FHA is a government program that serves a vital purpose and as such should be actuarially sound at all times. I hope my testimony helps you determine the best course of action to achieve that goal. In the testimony, I will do the following:

- Summarize the role private mortgage insurance plays in the market and then discuss the industry's regulatory structure.

- Summarize the differences between the way FHA and private mortgage insurers operate.

- Discuss why FHA now dominates the market.

- Provide the industry's insight into the recent actuarial study.

- Suggest some changes to FHA that could help increase its capital levels.

The Role of Private Mortgage Insurance

The private mortgage insurance industry has greatly expanded homeownership opportunities for Americans. Since the industry was founded in 1957 it has helped more than 25 million people buy homes with low down payments.

Because mortgage insurers have their own capital at risk and are in a first loss position if the loan goes to foreclosure, mortgage insurers' interests are aligned with those of the borrower, servicer and mortgage investor. This ensures better quality mortgages. Mortgage insurers act as a second set of eyes by reviewing the credit and collateral risks related to individual loans. This role protects both borrowers and investors by ensuring that the home is affordable at the time of purchase and importantly throughout the years of homeownership.

The Regulatory Structure of MI

MI is a regulated, counter-cyclical source of loan level protection provided for a mortgage loan, based on independent, objective underwriting criteria. This third-party credit enhancement expands mortgage credit availability, especially for loans with high loan-to-value ratios, because third-party capital is deployed to back this risk. This is particularly important under current market circumstances to ensure ongoing credit availability in this sector at a time when U.S. banks are under significant capital constraint that otherwise would limit their ability to make these loans.

It is for this reason that global regulators have repeatedly reviewed and, then, confirmed the value of properly-regulated and appropriately capitalized private mortgage insurance. In January of 2010,[1] the Joint Forum urged member nations to ensure that

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

greater use of MI is part of their mortgage-reform efforts. The Joint Forum is an advisory committee comprised of global banking, securities and insurance regulators. In addition to urging greater reliance on MI, the Joint Forum paper described the need to ensure that capital credit and regulatory recognition is provided only when private MI is in fact well regulated and capitalized, noting the significant problems that result from reliance on products such as credit derivatives.

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

Now, the FSB is proposing specific mortgage-underwriting standards to guide specific rules for residential finance.[4] MICA strongly supports the FSB's recommendations, which recommend reliance on private mortgage insurance subject to prudential regulation such as that governing the industry in the United States.

The backbone of the private mortgage insurance industry's ability to pay claims through this extreme down cycle in the mortgage market is its state-imposed reserve requirements. The reserve requirements were developed in a model MI act that was established by the National Association of Insurance Commissioners (NAIC) and is primarily enforced by the states where MI companies are domiciled. The requirements are specifically structured to address the long-term nature of MI risk. They enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle.

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

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

[3] Ibid, p. 25.

[4] Financial Stability Board, *FSB Principles For Sound Residential Mortgage Underwriting Practices* (Oct. 26, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111026b.pdf.

Chart 1 demonstrates how the MI industry builds its capital base during good times to pay claims in bad times like those currently experienced by the housing market. The chart shows yearly industry losses paid as a percentage of premiums earned for each year from 1980 through 2010. It also shows the MI industry's risk to capital ratio for each year and the build-up of premiums available to pay claims over time. As can readily be seen, the fact that mortgage insurers are required to keep a portion of the premiums in a contingency reserve means that premiums available to pay claims increase during the good times so they can be paid out to cover the serious losses that occur during the bad times.

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

The history of the MI industry shows that we have paid our claims through all economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated -- particularly in energy-oriented regions of the country -- defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims primarily in California and the Northeast.

In the lead up to the present crisis, the industry early saw warnings of critical risk in the residential-mortgage market and tried through comments, meetings and other venues to get U.S. regulators to take urgent action to improve underwriting and securitization practices. Had the industry's warnings been heeded, while the crisis might still have occurred we believe it would not have proven to be the grave macroeconomic threat still blocking robust U.S. recovery. In its warnings to regulators starting in 2002, MICA repeatedly said that dangerous practices would "pollute the well" – that is, create risk for the prudently-underwritten loans backed by MI because problems on individual loans without these safeguards would drag the entire mortgage market into crisis.

However, private mortgage insurers have fared remarkably well despite severe stress. For example they have remained viable even as more diversified mortgage-finance operations like the GSEs failed. To date since the current crisis began, MIs have provided $28 billion in claims and receivables to the GSEs, reducing taxpayer losses by 15%.

But, as the crisis has dragged on, sound MI firms have been under growing stress due in part to the "pollute the well" problem. This has undermined the ability of several firms to write new business. Still, these firms are paying their claims in the "run-off" process stipulated by state regulators that ensures that an MI's commitments are honored even under acute stress. This – combined with the resilience the industry has shown despite the severity of the crisis – proves the soundness of the private MI business model and the stringency of state regulation.

Comparison of Private MI to FHA

While FHA and MI are similar in that they enable borrowers to buy homes with less than a 20% down payment there are some significant differences in the way the two models are structured which are discussed below.

- Private sector capital at risk – Private mortgage insurers have their own capital at risk on every loan they insure in the first dollar loss position. This means a mortgage insurer's claim payment stands in front of any loss of other parties to the transactions. As a result, MI acts as a bellwether for the risk to the borrower. Of course FHA is not private sector capital and, therefore, is not similarly situated.

- Coinsurance feature – An essential feature of private mortgage insurance is the concept of coinsurance on the part of all parties to the transaction. MI generally covers 20% to 30% of the loan amount. However, that percentage generally does not cover all of the losses that the parties to the mortgage transaction experience. FHA, on the other hand, insures 100% of the loan amount if the loan goes to foreclosure so that the loan originator lacks any meaningful risk of loss. Coinsurance is essential to ensure that all parties to the transaction have an alignment of interest which in turn results in better originations.

- Respond to market conditions – 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. Mortgage insurers, on the other hand, have heavily invested in analytical and automated underwriting tools so that we make sure the loans we insure meet our independent underwriting criteria. Mortgage insurers are constantly monitoring the regional mortgage markets and altering their underwriting to ensure that the home is both affordable for the borrower at closing and sustainable over the life of the mortgage. If there is one thing the mortgage market has learned in recent years it is that sustainability is as important as affordability.

- Second Set of Eyes – Mortgage insurers have underwriting criteria independent of the lender or investor. MI companies provide a unique level of process oversight – sometime described as a second set of eyes – that can serve as an important check on third party errors, omissions and misrepresentation. FHA sets the underwriting criteria for the loans, but delegates the actual underwriting process to the lender. There is no review underwriting process.

- Appropriate Systems in Place – Over the last several years the HUD Inspector General and the General Accountability Office have enumerated various problems with FHA's underwriting and operating systems. Many of these problems have been addressed but others have been identified including problems arising with direct endorsement lenders. Because private capital is at risk, private mortgage insurers have the most current technology and can receive up-to-date information on their portfolios. This enables them to better understand trends in the market and set better underwriting criteria.

- Amount of down payment – The other characteristic that is different in today's market is the amount of a down payment that an FHA borrower must make as opposed to the down payment required by a mortgage insurer. FHA's minimum down payment requirement is set in law and is 3.5%. MICA's members make separate decisions on their down payment requirements and have the flexibility FHA does not have to make adjustments to reflect economic conditions. In today's market the lowest down payment requirement generally is 5%.

FHA Dominates the Market for Low Down Payment Loans

The federal government has dominated the mortgage market since the beginning of the crisis and FHA in particular has crowded out the primary source of purely private capital at risk in the mortgage market today – the private mortgage insurance industry. Private MI is a sector of the mortgage market that did not receive government assistance during the crisis and is still serving the market today. To illustrate FHA's dominance, Chart 2 compares the market share of FHA and private MI in the total mortgage market. Chart 3 shows their comparative market shares in just the low down payment/insured market. FHA's market share has increased dramatically since 2007, rising from 17% to 62% from 2007 through second quarter 2011.

Discussed below are the factors contributing to FHA's historic market share.

- FHA Loan Limits too High - FHA's loan limits are extremely high. For the first time in history, they are larger than Fannie Mae and Freddie Mac's limits. The floor for the FHA limits is particularly high and cuts significantly into private insurers' market. The lowest FHA limits in any area of the country is $271,050. However, the median existing house price in the country is $165,600 and in many areas considered to be high cost the area median house price is significantly lower than the FHA floor. For example, the California Association of Realtors reported that statewide the median existing single family house price in California in October was $278, 060 which is barely above the lowest FHA limit while in the Southern California counties of Riverside and San Bernadino the median house prices were $195,760 and $132,210 respectively.

- 100% insurance coverage – As noted above, FHA provides 100% insurance coverage if loans default. Mortgage insurers, on the other hand, insure 20% to 30% of the loan amount which means that in this housing environment all parties to the transaction have skin in the game.

- Lower Down Payment – As noted above, by statute FHA's minimum down payment is 3.5%. While individual MIs set their own down payment, it is generally 5%.

- Inadequate premium – While FHA has made important strides recently to bring its premium in line with the risk it is taking, it needs to do more. Under the law FHA can charge an upfront premium of no more than 3 percent that can be financed as part of the mortgage amount. The annual premium can go no higher than 1.55% of the insured principle balance depending on the LTV. Presently the upfront premium is 1% and the annual premium varies between 1.15% and .25% depending on the LTV, loan's purpose and the term of the mortgage.

- Fees on GSE loans - Private MI is being priced out of the market because the Government Sponsored Enterprises (GSEs) are charging additional fees on top of the mortgage insurance premium. The vast majority of loans private mortgage insurers insure are sold to Fannie Mae and Freddie Mac. Fannie and Freddie have been charging delivery fees that primarily apply to low down payment borrowers and can go as high as 3.5% depending on the borrower's credit characteristics, loan-to-value ratio, mortgage product type and type of housing.

In fact**,** the HUD report to Congress notes that the FHA and private MIs do not play on a level playing field. HUD clarifies that conventional borrowers are put at a disadvantage to FHA borrowers because of the GSEs' loan level fees. The report notes that "even loans for which private mortgage insurance costs might be comparable or even lower than FHA prices, the delivery fees charged by Fannie Mae and Freddie Mac can make such loans inaccessible to homebuyers with limited wealth." It also notes that "Fannie Mae and Freddie Mac do not currently purchase loans with down payments of less than 5 percent."[5] While these facts benefit FHA today in that borrowers who would otherwise use private insurance move to the government program, it seriously impedes the redeployment of private capital in the mortgage markets and should be addressed from a public policy perspective.

Actuarial Study

The FY 2011 actuarial report for FHA's mutual mortgage insurance (MMI) fund raises key points which should be of concern to Congress. First, although press reports have focused on the capital ratio for the entire MMI Fund at 0.24%, in fact, the capital

[5] See pages 20 to 21 of the HUD Report to Congress.

ratio for the most important and by far the largest part of the MMI Fund – the traditional 1 to 4 family 203(b) program - is only 0.12%. This is a ratio of 846 to 1. The much smaller reverse mortgage (Home Equity Conversion Mortgage) part of FHA is projected to have just under a 2% capital ratio and this fact brings the entire MMI Fund to a 0.24% capital ratio.

Looking only at the key single family business, there is only $1.193 billion of economic net worth against $1.009 trillion of insurance in force. Since FHA insures 100% of the loan amount this is $1 trillion of FHA risk in force – potential risk to the taxpayer -- supported by only $1.2 billion of economic net worth.

Second, FHA, continues to suffer heavy losses from its 2007-2009 books of business and especially its loans with seller contributions—a product that ended with passage of the Housing and Economic Recovery Act (HERA) in 2008. The $28.2 billion in capital reserves of the single family program were depleted by $26.9 billion in negative future cash flows on existing business with $24 billion of this negative cash flow attributed to the 2007-2009 books alone.

Looking ahead, under the base case scenario, the FHA actuarial report projects that claim payments in FY 2012 will be over $35 billion or more than twice as much as paid in FY 2011. This will result in a net cash outflow of $19.5 billion leaving the MMI capital resources at only $13 billion at the end of FY 2012 or 60% less than at the end of FY 2011.

In addition to the seller contribution mortgages noted above another important factor in generating the losses to the 2007 – 2009 books is that the FHA premium during those years was set at far too low a level to cover the risk inherent in the loans it guaranteed. As noted above they are still too low, but FHA has taken steps to improve them. Part of the problem is attributable to the fact that FHA insures 100% of the unpaid principal balance of the insured loan amount. This exposes the MMI Fund to the full force of falling house prices, especially in areas which have suffered tremendous house price bubbles followed by serious declines.

The FY 2011 actuarial study notes that the loss severity has been steadily increasing since FY 2003 for the MMI Fund due in large measure to the house price declines. However note the serious loss severity rates as shown in the most recent study. For loans that terminated in FY 2009 the report shows a loss rate of 63.67%.[6] This was up from 59.4% in FY 2008, 49.4% in FY 2007 and 41.75% in FY 2006. In other words, for loans that were terminated in FY 2009 the average loss experienced by FHA equaled 64% of the unpaid principal balance on the loan. The report provides no data on more recent average loss severities but from our own experience in the markets it is highly unlikely that the severity rates fell during the past two years.

[6] See Exhibit E-1, page E-2 of the Report.

Recommendations to improve FHA

- Increase premiums – Although FHA has raised its premiums twice in the past year the current health of the MMI Fund justifies an immediate increase in the premium. The annual premium should be set at the limit to which Congress allows. Current annual premiums are set at either 1.10% or 1.15% depending on the initial down payment by the borrower. FHA has the authority to raise these fees to 1.50% and 1.55% which would clearly improve the finances of the MMI Fund over time. Further to assure that the MMI Fund reserves can be built up to a level that provides a greater cushion for the taxpayer should house prices fall in the near term, we believe that FHA should be required to keep premiums at this higher level until FHA's capital ratio goes back to 2% and for several years thereafter.

- Increase the minimum down payment – In view of the market realities today of falling or stagnant home prices, FHA's down payment requirements should be increased to 5%.

- Change the way FHA's loan limits are calculated – FHA's loan limits should be lowered to what they were prior to the crisis. Importantly, the way FHA's loan limits are calculated is designed to skew them so they are as high as possible. First, FHA uses house price data going back as far as 2008 rather than the most currently available data if the use of the earlier data prevents the FHA loan limit in an area from falling. This means that while some areas of the country have their FHA loan limits set using 2008 median house price data other areas use 2009 data or 2010 data whichever results in a higher FHA loan limit. FHA uses this approach as a result of its reading of the Congressional intent under laws passed in recent years. We believe Congress should instruct FHA to use the most currently available house price data in setting its limits for an area so that the FHA limits are realistic given the change in median house prices for an area over time.

  In addition, currently under law (12 U.S.C. 1709), if a house is located in a county which is part of a Metropolitan Statistical Area (MSA), then the FHA mortgage limit for that county is set at the median house price for the highest priced county within the entire MSA. This means that all counties within a given MSA have the same FHA loan limit and that limit is set at the level of the median house price in the highest priced county. Prior law (before 1998) had FHA set the limit at the higher of either the county median house price or the median house price for the MSA as a whole without reference to the highest priced county within the MSA. We believe that the law should be changed so that FHA is no longer required to target its MSA limits to the highest priced county within an MSA.

- Eliminate GSE fees – The fees charged by the GSEs on top of the MI premium should be eliminated. It is clear that the GSEs are charging these fees as a credit risk mitigation tool. However, there is no indication that these fees go into a regulated reserve structure similar to the reserve structure required for private mortgage insurers. Importantly, if the GSEs believe that they need more credit risk protection for the loans they purchase, they can require deeper MI coverage. In other words, mortgage insurers could insure more than 20% to 30% of the loan amount and the cost to the borrower would be less expensive than the GSE fees in addition to the mortgage insurance premium.

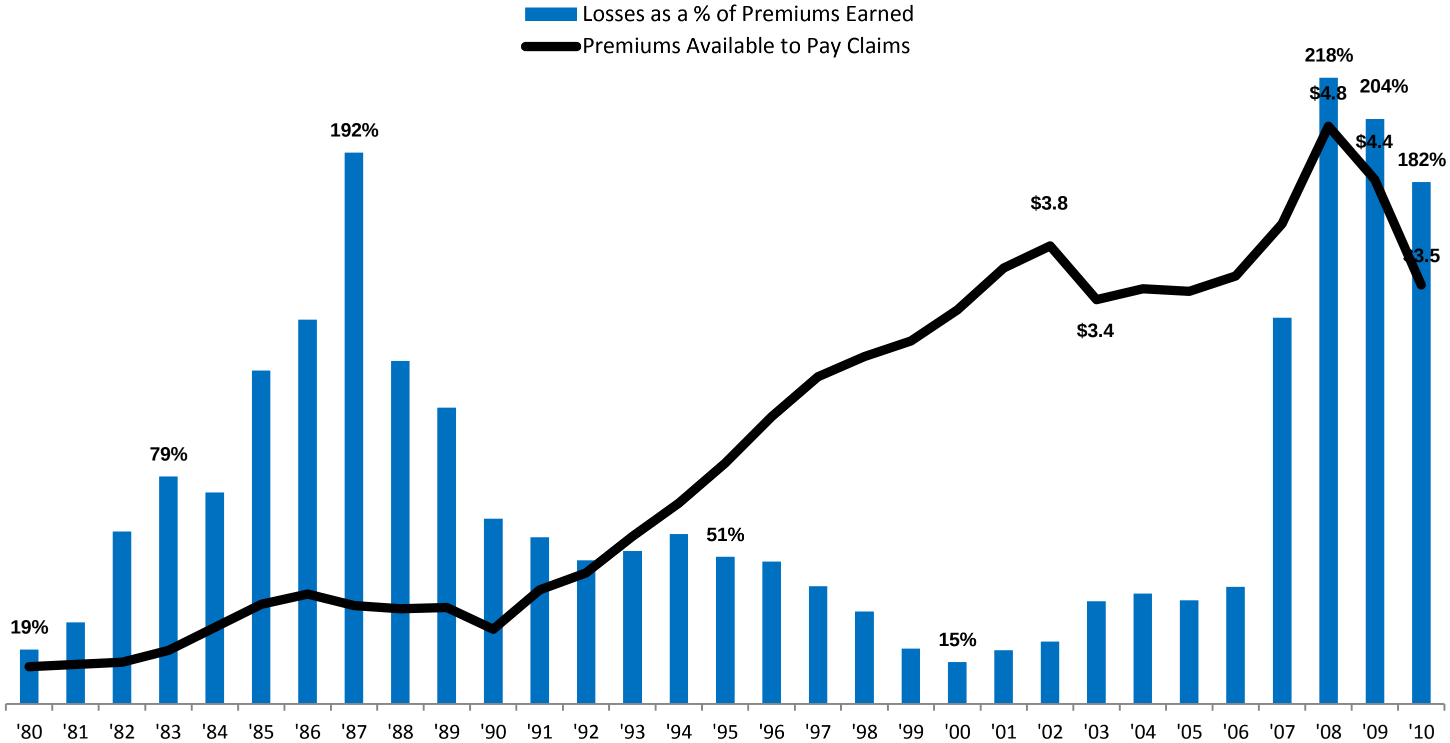
- Work with FHA – As note above private mortgage insurers have a number of strengths that FHA does not have and these have enabled them to survive this present crisis. Primary among those strengths are our analytical tools and underwriting capabilities. MICA believes FHA could be enhanced by exploring with private mortgage insurers new ways to work together to both mitigate taxpayer exposure to losses on low down payment mortgages while better defining the role each of us should play in providing credit enhancement for home buyers. Secretary Donovan has expressed a desire to return FHA's market share to its historical norm and the mortgage insurance industry stands ready to work with him on this issue.

Conclusion

In conclusion, we believe that just like in 1990, FHA is at a crossroads and there are some concrete steps Congress can take to return FHA to actuarial soundness. First, FHA should raise its premiums to the maximum Congress has authorized. Second, FHA should consider raising its minimum borrower down payment. Third, Congress should instruct the FHFA to require that the GSEs eliminate their supplemental loan level fees to avoid the creation of a barrier to the return of private capital to the mortgage system. Finally, the mortgage insurance industry also is willing to work with FHA so that we can build on each other's strengths to better serve the market.

Chart 1

Private Mortgage Insurers Build Capital in Good Times to Pay Claims in Bad Times



Industry Risk to Capital*:	19.4	21.5	22.4	20.8	22.2	20.2	20.3	17.8	13.5	11.1	9.9	8.0	15.6	21.6

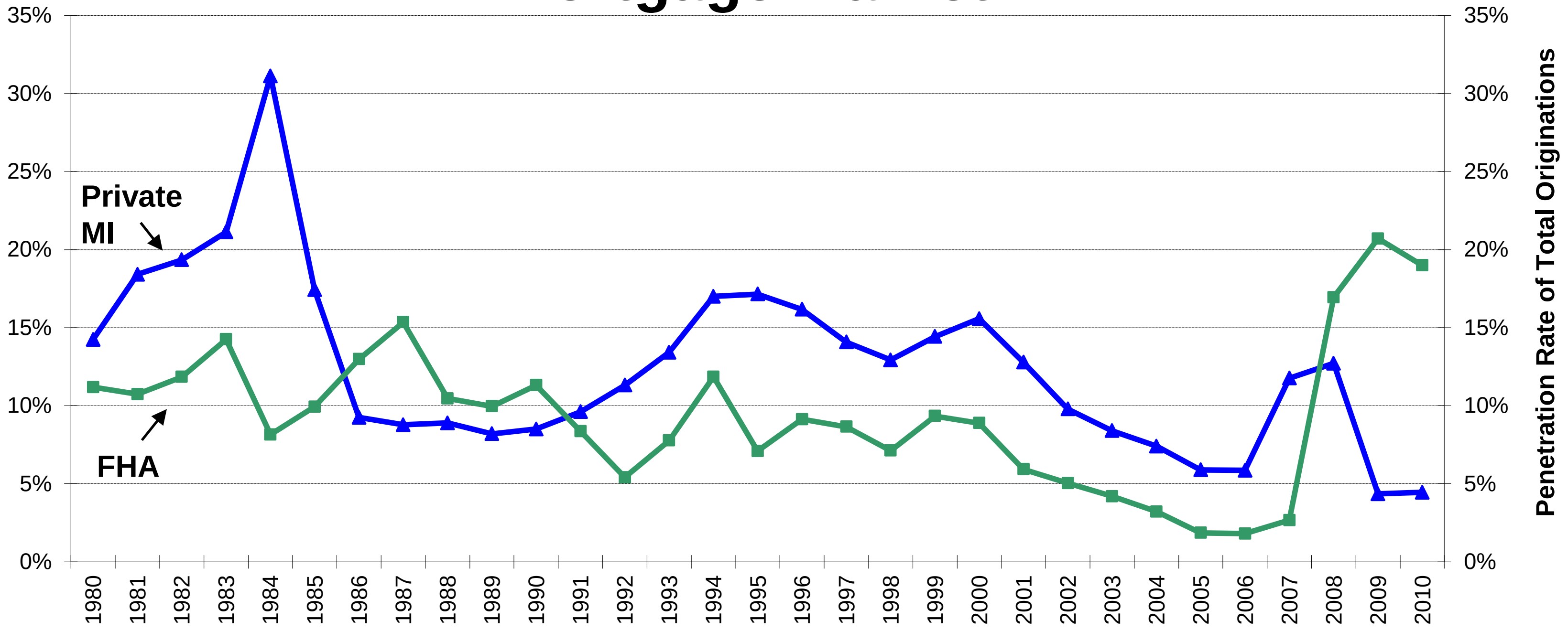
- Mortgage insurance is priced for long-term cycles.
- MIs build capital in good times by setting aside 50% of all earned premiums to pay claims in economic downturns.
- New business in a recovering economy rebuilds the companies' capital base and replenishes their contingency reserves.

*Dollar amount of industry net risk on insured mortgages, divided by industry regulatory capital. Years 2006, 2008, and 2010 risk to capital are adjusted to remove delinquent risk and risk ceded to third-party reinsurance entities.

Source: MICA.

Chart 2

Private Mortgage Insurance and FHA Percentage of Mortgage Market



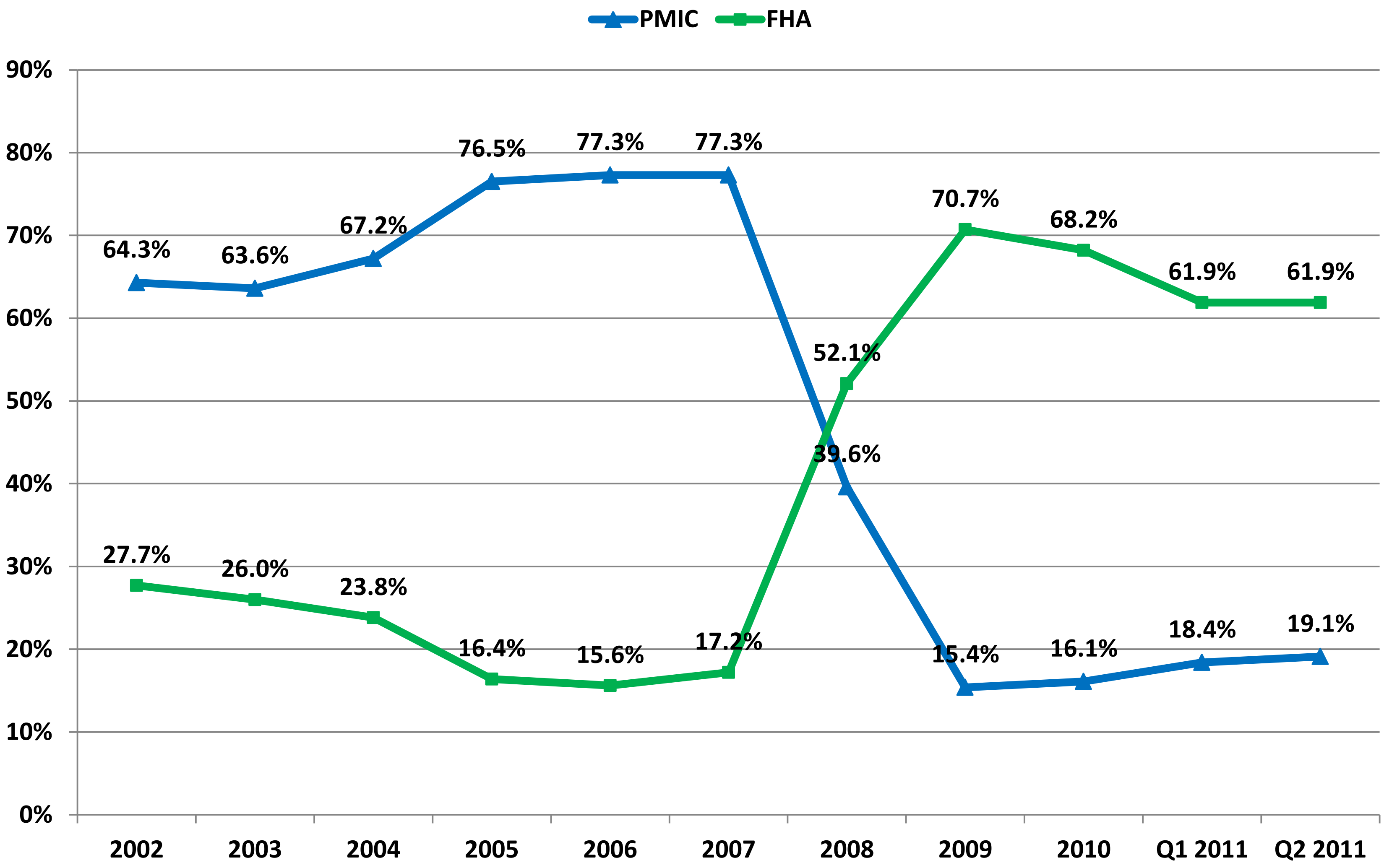
Total MI & FHA 25% 31% 39% 22% 19% 20% 17% 29% 25% 20% 24% 15% 11% 8% 30% 23%

Prudent Low Down Payment Lending Critical to Recovery

Significant Imbalance Between Government Backed and Private Mortgage Insurance

Sources: Private MI data from MICA (excludes HARP), FHA Data from February 18, 2011 Inside Mortgage Finance, Origination Data from March 4, 2011 Inside Mortgage Finance.

Chart 3
Mortgage Insurance Activity: 2002-Q2 2011



Source: November 11, 2011 Inside Mortgage Finance.