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Before

House Financial Services Subcommittee on Housing & Insurance

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Future of Housing In America: Oversight of FHA – Part II

Chairman Leutkemeyer and Ranking Member Cleaver, thank you for the invitation to testify before the House Financial Services Subcommittee on Housing & Insurance. My name is Rohit Gupta and I am the President and CEO of Genworth Mortgage Insurance. I also serve as Chairman of U.S. Mortgage Insurers ("USMI"), a trade association that began operations in 2014. USMI represents six of the industry's seven private mortgage insurers and is based here in Washington.

As private mortgage insurers, we play both a complementary and a competitive role with the Federal Housing Administration – the "FHA" -- by making it possible for home ready borrowers to purchase a home with less than a 20% down payment. We appreciate the opportunity to testify this morning on the important topic of the ongoing role of the FHA, and to answer the subcommittee's questions.

In my testimony this morning, I will cover the following topics:

- How private MI works, and how our industry differs from the FHA program –and why those differences matter.
- How private MI weathered the housing crisis, the lessons we learned and how we have used those lessons to strengthen our business model.
- How private MI is positioned to play an even more significant role to facilitate a stable and strong housing market going forward as work on housing reform continues.

<u>How Private MI Works – MI vs. FHA.</u>

The private mortgage insurance industry has been in existence for over 50 years. It is the primary form of private capital-backed credit enhancement for low down payment loans. We are regulated by state departments of insurance. States oversee our business conduct, review the rates we charge and establish capital requirements, generally at a risk to capital ratio of 25:1 (four percent of risk insured). In addition, Fannie Mae and Freddie Mac impose MI eligibility

requirements that an MI must satisfy in order to be eligible to do business with the GSEs. Those standards, known as PMIERs, have been in place for decades and are in the process of being updated. The updates will include significantly higher capital requirements going forward.

Private MIs insure loans with down payments as low as three percent for borrowers with FICO scores down to 620. We underwrite loans based on a variety of factors. Our underwriting is grounded on the "3 Cs" of underwriting – credit (what is the borrower's history of managing his or her credit), capacity (does the borrower have the financial resources to meet his or her debt obligations) and collateral (is the down payment and home value sufficient to support the amount being borrowed). In the past year, MIs helped almost 600,000 borrowers purchase or refinance their homes. Almost half of the loans we insured went to first time homebuyers, and approximately 40% went to borrowers with incomes at or below $75,000.

FHA is a government guaranteed mortgage insurance program that was created in 1932. While the dimension of the program has changed over the years, its primary mission continues to be targeted at low and moderate income borrowers, members of underserved communities and first time homebuyers. The program insures loans with down payments as low as 3.5%, charging an upfront premium which typically is financed into the loan amount, and an annual premium that is added to the borrower's monthly mortgage payment. FHA insurance essentially covers 100% of losses in the event a borrower defaults, and the insurance coverage remains in place for the life of the loan.

The FHA's insurance fund is subject to a minimum statutory capital reserve requirement of two percent of the risk insured, although the FHA is permitted to continue insuring loans even if its capital falls below that statutory minimum. The FHA's capital ratio is currently 0.41% of risk insured, one-fifth of the required minimum.

The very business of the private MI industry is to put its own capital at risk in a first loss position on the loans we insure. This matters for several reasons, especially:

- Because we put our own capital are risk, we have a powerful incentive to verify that the loans we insure are prudently underwritten and sustainable. And, if a borrower experiences hardship, it makes good business sense for us to help that borrower stay in the home and avoid foreclosure. So our capital at risk aligns our interests with those of borrowers, mortgage lenders, investors and the overall housing market.

- Taxpayer risk is extremely remote on loans we insure. In the unfortunate event a loan defaults, borrower equity and our MI claim payment stand ahead of any GSE guarantee. In many cases, losses to the GSEs are far less on defaulted loans with MI than on bigger down payment loans that do not have MI coverage. See the Housing Finance Policy Center Brief entitled "Loss Severity on Residential Mortgages, Evidence from Freddie Mac's Newest Data" published by the Urban Institute in February 2015 for more on how MI mitigates losses to the GSEs.

- The MI business model builds capital during strong markets so that capital is available to pay claims during downturns. Mortgage insurance premium income, capital and reserve

requirements combine to provide countercyclical protections against housing downturns. During times of market stress (for example, the "Oil Patch" in the mid-1980s), mortgage insurers experienced high levels of losses and our risk to capital levels rose accordingly. As markets stabilize, higher earned premiums and lower claims paid typically enable the industry to replenish our capital base. This countercyclical model was severely tested by the global financial crisis, and as expected, risk to capital ratios rose in the face of unprecedented losses. In recent years, housing markets have recovered, loan performance has improved, MIs adjusted our guidelines and pricing, and our industry has attracted significant amounts of new capital. These factors have combined to result in materially improved risk to capital ratios. Today, our industry is well positioned to pay claims and write new business.

<u>How MI Weathered the Crisis/Lessons Learned.</u>

Like all of the housing finance market, our industry faced unprecedented challenges as a result of the global financial crisis. But USMI member companies never stopped paying claims, and we never received any bailout money from the federal government. Since the onset of the housing crisis, our industry has covered over $44 billion in claims to the GSEs, claims that otherwise would have been on the shoulders of taxpayers. And we have attracted approximately $10 billion in new capital during this time. Three MI companies did exit the business, but they all continue paying claims. In addition, three new companies have entered the business since 2008: a significant vote of confidence in the private MI business model [See Appendix A for a snapshot of the state of the MI industry].

Coming through the housing cycle, we heard concerns from investors and counterparties regarding our willingness to pay claims, our ability to pay claims and lack of transparency into our claims paying practices. And we addressed each of those concerns, working closely with state regulators, FHFA and the GSEs. We have significantly shored up our capital with all companies operating at capital ratios of 18:1 or better. This is equivalent to capital of at least five percent of risk insured for all MIs. In October 2014, each MI put into effect new master policies that provide contractual certainty regarding how and when we pay claims. Later this year, the GSEs and FHFA will finalize revised PMIERs that will require our industry to operate under new risk-based capital requirements significantly higher than our current requirements. The revised PMIERs will represent a reliable, transparent and comprehensive counterparty framework that sets standards for both capital and operational capacity for our industry.

<u>The Role of MI Going Forward.</u>

The Committee asked us to comment on FHA's role as it relates to the re-entry of private capital. Our industry differs from the FHA in some fundamental ways, and those differences enable private MIs to play an important role in a sound and stable housing finance market. FHA and private MIs can and should serve as complementary forces that enable the FHA to remain focused on its fundamental mission of serving underserved markets that the private sector may not be best suited to reach. But for this model to work properly, it is critically important that the FHA not stray too far afield from that mission [See Appendix B for a high level comparison of Private MI and FHA].

The recent decision to lower annual mortgage insurance premiums at FHA, for example, has two immediate consequences: (1) it slows the trajectory of FHA attaining the 2% minimum capital requirement; and, (2) it limits the ability of private MI companies to serve their traditional role in higher LTV markets [See Appendix C for charts detailing the impact of the FHA price decrease]. These consequences matter for a housing finance system that is still rebounding from the 2007-2008 cycle and for a system – by most every account – preferring the return of private capital to support U.S. housing finance.

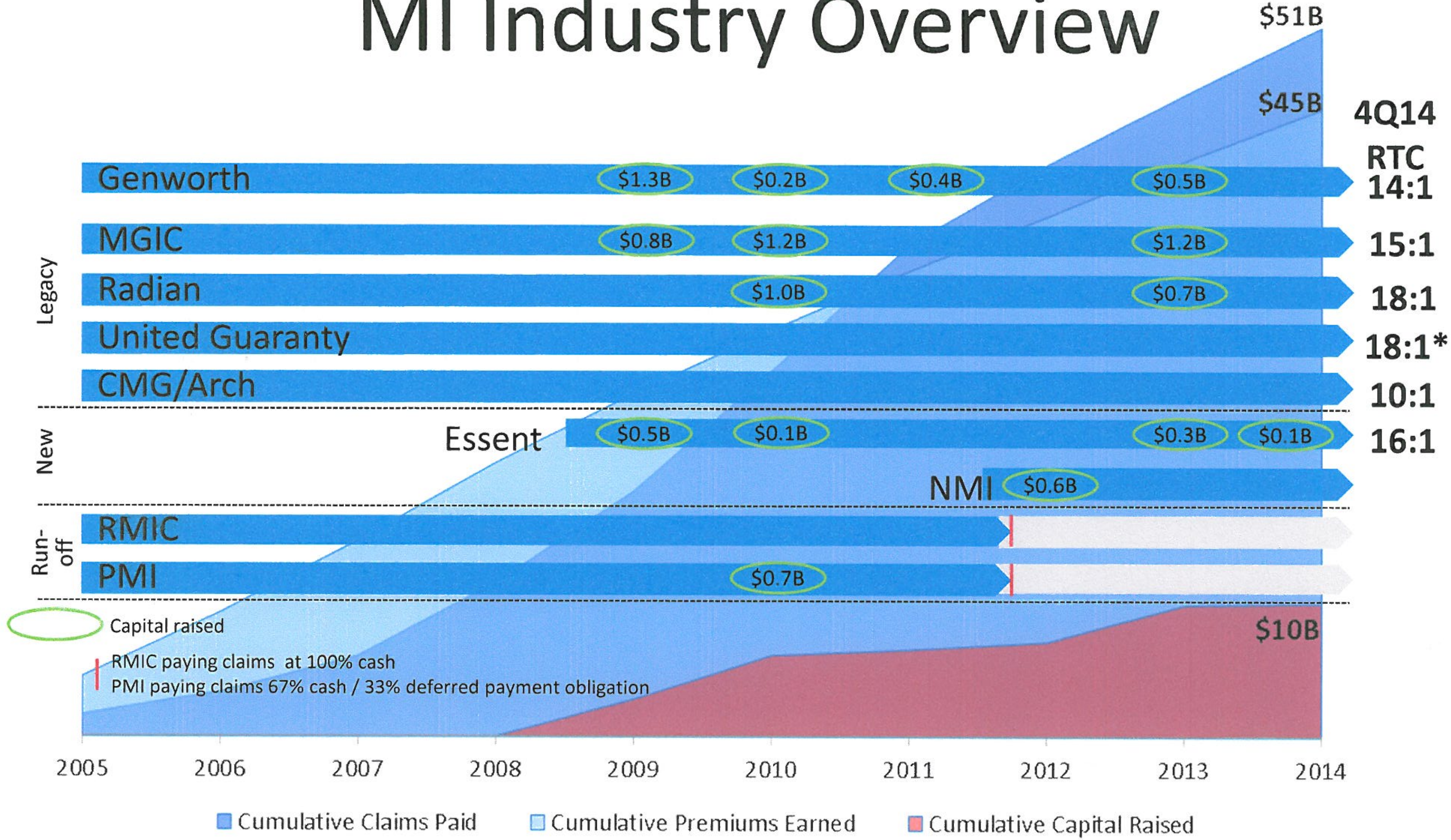
To summarize, the private MI industry is not merely "an alternative to FHA," we are a highly capitalized, strongly regulated, proven countercyclical credit enhancement that reduces taxpayer exposure. We are among the best positioned to continue to serve the housing market as it exists today and as you consider housing finance reform going forward. The current application of Standard Cover private mortgage insurance is a very good place to start – as recognized in most of the GSE reform efforts included in the 113th Congress [See Appendix D for a description of Standard Coverage]. But more can be done to make the risk to the federal government even more remote:

- Beyond or in addition to Standard Cover, encourage supplemental or deeper private credit enhancements to further distance the government exposure; and,
- Encourage the use of additional risk sharing to transfer real risk from the government balance sheet – both the GSEs and with FHA – over to private MIs.

As Congress continues the important work on comprehensive housing finance reform, we strongly believe that reform should include a single industry wide standard on QM (Qualified Mortgages); there should be a single industry standard for permissible seller concessions (three percent permitted in the conventional market); and there should be a common sense approach to FHA loan limits tied to current home prices in each geographic region.

We appreciate the opportunity to testify before this subcommittee and look forward to responding to any questions you may have.

Appendix A



Note: Excludes any capital benefit from reinsurance agreements entered into in 2008. Claim and Premium data through 3Q14.
Sources: SEC/GAAP for GNW, MGIC, Radian, UG. Combined Yellow Book Data Pre-2013 for GNW, MGIC, Radian, UG, PMI CMG, Essent, RMIC. RTC ratios disclosed by each MI.
* United Guaranty discloses Risk To Capital ratio on a lag. 3Q14 shown here.

Appendix B

When It Comes To Protecting Taxpayers, There's No Comparison
Private Mortgage Insurance (MI) vs. FHA

Issue	Private MI	FHA
Who Bears the Risk In a Default	Private capital assumes the credit risk in a first loss position.	The FHA assumes 100 percent of the risk so given the under capitalization of the MMI fund, taxpayers are at risk if there are not sufficient funds available for FHA to pay its claims.
Taxpayer Impact	Covered approximately $44 billion in losses on loans sold to the GSE's since they entered conservatorship, losses that otherwise would have been shouldered by taxpayers.	The FHA insurance fund required $1.7 billion from U.S. taxpayers due to a capital shortfall. Even after this bailout, and with additional funds from one-time litigation settlements and enforcement actions, the fund is *still* undercapitalized.
How Price is Determined	More granular, risk based rates based on robust actuarial analysis and a real cost of capital, requiring state level filings.	Flat pricing structure based on limited actuarial modelling with little approval oversight.
Underwriting Incentives	Covers first losses down to a stated coverage percentage. The potential for some lender/investor loss in severe cases creates strong incentive for prudent underwriting and strong servicing.	Covers 100 percent of losses if a loan defaults, which may provide less incentive to ensure that loans are underwritten and serviced in prudent and sustainable manner.
Capital, Leverage, and Oversight Requirements	Required to be at a minimum capital ratio of 4 percent. All MIs are reporting risk to capital ratios less than 18:1. Even higher capital standards will be required under final GSEs Private Mortgage Insurer Eligibility Requirements (PMIERs).	Required to be at a minimum capital ratio of 2 percent. FHA insurance fund is at a 0.41 percent capital ratio, well below the two percent statutory minimum. FHA insurance fund has been below 2 percent since 2009, is not expected to reach 2 percent until 2017 at earliest, and will not reach more prudent 4.5 percent level suggested by analysts until the mid-2020s.
Coverage	For most premium plans, by federal law, coverage (and premiums) cancels when the loan LTV reaches approximately 78 percent.	Stays in place for the life of a loan. Therefore, it is essential that FHA charge borrowers premiums throughout the life of each loan. FHA loans are also assumable (meaning a new borrower can assume the mortgage loan and the FHA insurance stays in place), which makes life of loan coverage necessary.

Appendix C

FHA Premium Reduction Will Impact FHA and Private MI Market Share

Impact of FHA Price Decrease With Typical Ginnie Mae/GSE Bond Spreads:

		FHA	Conventional (by FICO)									
			620 - 639	640 - 659	660 - 679	680 - 699	700 - 719	720 - 739	740 - 759	760 - 779	780 - 799	800+
BEFORE	85% LTV	$1,262	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90% LTV	$1,337	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95% LTV	$1,411	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97% LTV	$1,443	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451
AFTER	85% LTV	$1,174	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90% LTV	$1,243	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95% LTV	$1,312	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97% LTV	$1,343	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451

Assumes $250,000 home price, 4% FHA rate & 4.5 - 5% Conventional mortgage rate

The Impact of FHA Price Decrease Is Material Even With Unusually Tight Bond Spreads*:

		FHA	Conventional (by FICO)									
			620 - 639	640 - 659	660 - 679	680 - 699	700 - 719	720 - 739	740 - 759	760 - 779	780 - 799	800+
BEFORE	85% LTV	$1,262	$1,199	$1,199	$1,187	$1,144	$1,131	$1,108	$1,102	$1,095	$1,095	$1,095
	90% LTV	$1,337	$1,330	$1,316	$1,303	$1,250	$1,243	$1,205	$1,199	$1,189	$1,189	$1,189
	95% LTV	$1,411	$1,491	$1,477	$1,462	$1,382	$1,375	$1,308	$1,301	$1,285	$1,285	$1,285
	97% LTV	$1,443	$1,596	$1,574	$1,560	$1,504	$1,504	$1,447	$1,440	$1,429	$1,429	$1,429
AFTER	85% LTV	$1,174	$1,199	$1,199	$1,187	$1,144	$1,131	$1,108	$1,102	$1,095	$1,095	$1,095
	90% LTV	$1,243	$1,330	$1,316	$1,303	$1,250	$1,243	$1,205	$1,199	$1,189	$1,189	$1,189
	95% LTV	$1,312	$1,491	$1,477	$1,462	$1,382	$1,375	$1,308	$1,301	$1,285	$1,285	$1,285
	97% LTV	$1,343	$1,596	$1,574	$1,560	$1,504	$1,504	$1,447	$1,440	$1,429	$1,429	$1,429

Assumes $250,000 home price, 4% FHA rate & 4.5 - 5% Conventional mortgage rate

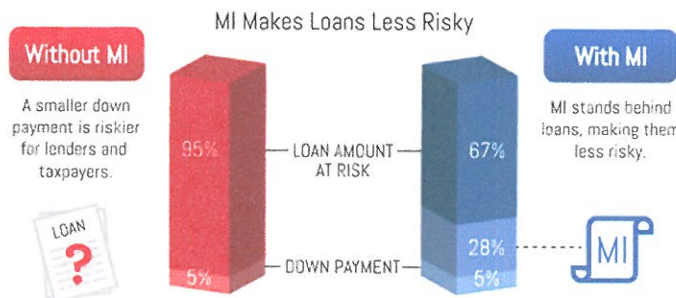
***Immediately following announcement of the FHA price decrease, the bond spread fell as low as 25bps due to the sharp increase in FHA refinances. Spreads have since widened and are expected to return to a more traditional ~100bps as the pace of FHA refinances slows.**

Appendix D

Private Mortgage Insurance (MI) plays a significant role in making taxpayer risk more remote on low down payment GSE loans. The GSE charters set minimum requirements for MI coverage, known as "Charter Coverage" because it satisfies the legal charter requirement. However, while charter coverage is legally sufficient, it does not afford any additional economic protection against loss from default, and is not commonly used in the market today. Instead, FHFA and the GSEs either require deeper coverage ("Standard Coverage") or charge significant loan level fees to self-insure against the additional risk associated with shallow charter coverage. Standard coverage brings loan exposure down to less than 75% of property value so that, except in the case of extremely severe declines in a home's value, the GSEs incur no losses.

For nearly 20 years the market practice for GSE loans has been to use standard coverage, which has served the housing finance system well and represents a vital source of private capital on GSE loans, providing substantial taxpayer protection at an affordable cost to borrowers.

Standard coverage was appropriately made part of most housing reform proposals. The benefits of standard MI coverage should be preserved when considering policy alternatives to ensure that taxpayers are at a more remote risk of loss in any reformed system. Indeed, deeper and broader use of MI could readily limit taxpayer exposure further. Importantly, the expanded use of MI is fully compatible with the functioning of the GSE (TBA) securitization market, which is vital to providing borrowers access to affordable 30-year fixed rate mortgages. MI provides policy makers a tool already used by lenders of all sizes with which to build a new housing finance system where private capital stands in front of taxpayer risk.



ABOUT USMI

U.S. Mortgage Insurers (USMI) is dedicated to a housing finance system backed by private capital that enables access to housing finance for borrowers while protecting taxpayers. Mortgage insurance (MI) offers an effective way to make mortgage credit available to more people. USMI is ready to help build the future of homeownership. For more information, visit www.usmi.org