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Before the United States Senate Committee on Banking, Housing and Urban Affairs

“Public Proposals for the Future of the Housing Finance System II”

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Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am Greg Heerde, Managing Director of Aon Benfield and Aon Benfield Securities, and I am here today to discuss the role of private capital supporting lender's credit risk through mortgage insurance. Aon Benfield is the world's largest reinsurance intermediary, and Aon Benfield Securities, Inc. is an investment banking firm providing advisory services to insurance and reinsurance companies including capital raising, risk transfer securitization and mergers and acquisitions. Combined, we have a high level of visibility into all forms of capital available to support the mortgage insurance industry. The goal of this testimony is to communicate:

1. the significant role that private mortgage insurance currently plays in supporting residential housing transactions and the stabilization of the housing market post crisis;
2. the role for private reinsurance to support the mortgage insurance market;
3. the availability of additional private capital in various forms to support the future of the housing market as needed.

1. Role of Private Mortgage Insurance

Private mortgage insurance provides protection to lenders, investors, and most importantly, taxpayers by standing in the “first loss position” in the event that a borrower stops making mortgage payments. When a borrower defaults, private mortgage insurance pays the lender or investor 20% - 25% of the loan amount, mitigating a significant (and in many cases all) portion of the loss on the loan. Private mortgage insurance also expands home ownership by allowing qualified borrowers with less than the 20% prescribed down payment to purchase a home. Private mortgage insurance is an alternative to the Federal Housing Administration (“FHA”) mortgage insurance. Key differences from the FHA coverage include private mortgage insurance is generally lower cost, as it covers the top portion of the loan whereas FHA insurance covers 100% of the loan, and private mortgage insurance is available on a wider variety of loans with no maximum loan amount.

Mortgage insurers underwrite the underlying quality of the prospective borrower's creditworthiness and the supporting collateral thereby ensuring higher quality mortgages are issued. This protects not only the lenders and investors but the prospective borrowers by ensuring that the home is affordable at the time of purchase. Private mortgage insurers also have clear incentives to mitigate losses once loans are in default. As foreclosure results in the highest likelihood of loss payment under the insurance policy, mortgage insurers' goals are to work with borrowers to avoid foreclosure and keep them in their homes.

The mortgage insurance industry in the US is over 50 years old and has paid claims in a variety of adverse economic cycles. For example, more than \$6 billion of mortgage insurance claims were paid in the 1980s, when the US experienced double-digit interest rates and inflation. Similarly, in the early 1990s, mortgage insurers paid more than \$8 billion of losses primarily in California and the Northeast.⁽¹⁾

US private mortgage insurers have already paid approximately \$25 billion in losses during the current housing downturn, without government or taxpayer support, and the annual loss payments continue to climb. The largest beneficiary of these payments has and will be Fannie Mae and Freddie Mac, thereby reducing a material amount of the exposure to the taxpayer. US mortgage insurers are currently meeting their insurance obligations and most continue to write new mortgage insurance business, supporting the stabilization of the housing sector. In short, US mortgage insurance is acting exactly as intended and continuing to pay significant losses without government support in the wake of the most severe housing downturn in US history.

2. Role of Reinsurance

Reinsurance is another form of capital available to the insurance industry. Reinsurance is the transfer of insurance risk by an insurance company to a third party referred to as a reinsurer. Transferring insurance risk reduces the total amount of volatility the insurer is exposed to, and therefore the amount of capital required to absorb that volatility. Reinsurers, for example, have paid some losses associated with the current housing crisis.

Despite these losses, reinsurance capacity stands ready to be deployed more broadly going forward to support US mortgage insurers. Aon Benfield estimates that Global Reinsurer Capital totaled \$470 billion at December 31, 2010, representing a 17% increase over 2009 and the largest amount of capital in the history of the reinsurance industry. The total represents a full recovery following losses from natural catastrophes such as Hurricanes Katrina, Rita and Wilma in 2005 and earthquakes in Chile and New Zealand in 2010. Reinsurers in 2011 to date have experienced additional losses from earthquakes in Japan and the second New Zealand event, along with severe weather in the United States. The Aon Benfield Aggregate, which is a subset of Global Reinsurer Capital (representing approximately 53% of the total), currently has reported loss estimates from first quarter events totaling \$12.4 billion, with some companies still to comment on the extent of their exposures. However, Aon Benfield believes the losses to date fall within expected annual income and therefore will represent an earnings loss event rather than a capital loss event for the reinsurance industry.

Private reinsurers also play an important role supporting mortgage insurance in a number of other countries including Australia, Canada, and the United Kingdom. These countries have mortgage financing systems that are each unique, with varying government roles, but it is important to note that private reinsurance plays some part in all of them.

3. Availability of new capital to support the housing sector

The insurance industry by its nature protects against various sources of volatility. Through adequate risk pricing and risk selection, the industry is able to achieve a level of diversification

required to produce acceptable returns to capital providers. Following each major insured loss from man-made and natural catastrophes, reinsurers have brought material new and lasting capacity to the market. For example, after hurricane Katrina, over \$30 billion of new capital was raised to form new insurers and reinsurers. This capital meant that insurers were able to continue renewing policies that they would have otherwise not been able to renew.

Since the beginning of the financial crisis, new capital has come into the sector in the form of a new start-up mortgage insurer and as significant contributions to support existing carriers. To date, approximately \$8 billion of new capital has been raised⁽¹⁾, which by industry standards could enable the sector to support \$200 billion of insurance exposure. In addition to the capital that was raised, Aon Benfield Securities represented a qualified management team in 2009 through early 2010 seeking to form a new mortgage insurance company. This plan was ultimately shelved as the capital providers witnessed the substantial growth of the FHA during the period coupled with the uncertainty around the future of Fannie and Freddie, which was viewed as weakening the demand for mortgage insurance and therefore the need for new companies. Ultimately, the capital providers concluded that the existing mortgage insurers and the introduction of the one new company formed were sufficient to satisfy current and short term future demand. There were other efforts during the same time period to introduce new mortgage insurance companies in various forms, some of which received indications that they would not receive approval from Fannie and Freddie to write business resulting in those efforts being shelved as well. As such, a transparent path to achieving approval from Fannie and Freddie would further encourage private capital investment.

If, as a result of the review of various proposals for the future of the housing finance system, a decision is made to reduce the role of Fannie and Freddie over time, and that decision results in an increased demand for private mortgage insurance at commercially responsible terms, we are confident that sufficient private capital would be available to support that increased demand. Should the demand be sufficient to warrant the introduction of new mortgage insurance companies, and the necessary approval of qualified new mortgage insurers be attainable, we are equally confident that capital would form such new entrants. In addition, such a change in dynamics would likely result in more innovation in the underlying mortgage insurance product, which may ultimately result in a more competitive product as a benefit to both lenders and borrowers.

As indicated above, reinsurers are enjoying record levels of capital while total reinsurance premiums over the past few years have declined. Given the greater capital base chasing fewer premium dollars, reinsurers are eager to underwrite new risks. The lack of such new exposures has resulted in reinsurers returning capital to shareholders in the form of dividends and share buybacks (the companies comprising the Aon Benfield Aggregate returned \$17.6 billion, or approximately 73% of their 2010 net income to shareholders). Reinsurance capacity is clearly available to support mortgage insurers by providing capacity that will allow them to insure more loans as the housing market rebounds and demands for mortgage insurance grow as well as to limit mortgage insurers exposure to severe losses and help ensure the ability of the mortgage insurance market to effectively meet a range of potential future loss scenarios. Mortgage

insurance is generally not highly correlated to most other significant reinsurance exposures and therefore represents an attractive source of diversification for the industry.

Concluding Remarks

As this Committee considers proposals impacting the future of the housing finance system, we are encouraged to report that private capital providers have upheld their commitments made through the mortgage insurance channel, and additional private capital is available to inject fresh capital as needed. Further, reinsurers stand ready to assist in mitigating a portion of the mortgage insurance risk as long as prudent underwriting standards and reasonable pricing characterize the marketplace.

(1) Source is Mortgage Insurance Companies of America reports