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On "Addressing FHA's Financial Condition and Program Challenges, Part II"

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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 at the request of the Committee to discuss the mission and financial health of the Federal Housing Administration’s (“FHA”) single family insurance program. In my testimony, I will address some of the key questions concerning the mortgage crisis and its impact on both FHA and the private MI industry and, as requested, suggest ways in which the FHA program can be improved.

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. In the past few years, however, FHA has overtaken the mortgage insurance market due to increased loan limits, inadequately-priced FHA premiums, and permissive FHA underwriting. The recent crisis has identified areas where FHA should improve its internal controls to ensure its continued ability to meet its mission without taxpayer cost. 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. These actions are positive steps in the right direction to improve FHA’s financial condition and reduce taxpayer exposure; however, additional reforms, which I discuss in this testimony, are necessary.

It is also important to be mindful about other actions, such as increasing Fannie Mae and Freddie Mac (“GSE”) guarantee fees or 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 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 toward FHA loans and government insurance and away from private MI.

Ultimately, housing policies should work to scale back FHA to its traditional mission of supporting underserved borrowers, while enabling private MI, with its reliance on private capital, 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 low and moderate income people become homeowners by enabling them to buy affordable homes with small down payments. Today, about $900 billion in mortgage loans are currently insured by private MI.

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. The GSEs are the key providers of conventional financing today, and private MIs are the GSEs' key providers of credit enhancement.

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. 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.

Because the GSEs are now in conservatorship, once the loans are purchased by the GSEs, the government – taxpayers – 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 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 the recent, unprecedented housing downturn.

Importantly, placing the MI company's private capital at risk in a "first loss" position after the borrower means that both the mortgage insurer and the borrower have a vested interest in making home loans that are affordable not only at the time of purchase, but sustainable throughout the years of homeownership. Having their own capital at risk also means that mortgage insurers have very clear incentives to work with lenders, investors, and community groups to help borrowers in default stay in their homes.

The private MI industry has the resources to pay claims on existing loans and will continue to do so because of the rigorous, countercyclical capital and reserve requirements imposed by state insurance commissioners. Half of each premium dollar earned is required to go into a contingency reserve and generally cannot be touched by the mortgage insurer for 10 years. This ensures that significant capital reserves are accumulated during good times and then drawn upon to absorb losses during downturns.

Private MI companies also continue to insure new mortgages. Although capital limitations at a couple of private MI 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 we are insuring. The industry overall has more than enough capacity to insure the current and projected volume of low down payment loans. In fact, the industry has attracted over $7 billion in new capital throughout the mortgage crisis, and new entrants to the industry have raised over $1 billion in capital since the crisis began. 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 and sustainable mortgage loans while protecting taxpayers from the losses that result from borrower default.

A Brief History of the Mortgage Crisis as it Affected Private MIs 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 of the lenders' underwriting decisions, including the acceptance of low or no documentation loans by private mortgage insurers 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, they 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. 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 channeled by lenders to FHA. This adverse selection of FHA – a consequence of inadequate FHA premiums, delegated FHA underwriting to lenders, 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 MIs 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. All 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 recognize the negative impact of declining house prices until 2010. It was then that FHA chose to increase its premiums. By then, its market share had increased from 17% in 2007 to 68%. By the time the FY 2011 actuarial report was issued by the Department of Housing and Urban Development, the pre-2009 loans that had low premiums and lax underwriting accounted for 51% of FHA's 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 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.

[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.

Recommendations for the Future

The private MI industry has been gradually increasing its market share in recent years. 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 week—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. 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.

However, FHA remains the dominant player in the low down payment market for several reasons, which continue to jeopardize the FHA's financial health and now act to restrain the growth of the private sector. Reforms are necessary to scale back FHA to its stated goal of returning to its historical mission of supporting underserved borrowers and 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.

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 another 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 also reduce 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 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.

Other Issues Facing the Mortgage Market that Congress Should Address

Finally, I would like to take this opportunity to draw Congress's attention to two important issues that will serve to impede the ability of low down payment borrowers to obtain affordable and sustainable mortgage financing in the future unless the correct decisions are made by regulators.

QRM. First, regulators are today considering the appropriate mortgages to include within the Qualified Residential Mortgage ("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.

As proposed, the rule would significantly and unnecessarily impede the availability of private capital to serve low down payment borrowers, and the U.S. taxpayer will be asked to bear even more of the risk associated with low down payment borrowers.

Loans with down payments of 5% to 20% that otherwise meet the standards of a Qualified Mortgage should be included within the QRM exemption provided that they have first loss loan level insurance coverage by an adequately capitalized mortgage insurer. In fact, 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. Also, 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. With the addition of responsible and independent second underwriting by a mortgage insurer, both the borrower and the mortgage securitizer can be protected.

Basel III. Finally, the bank regulators have also proposed rules to implement Basel III in the United States. This Committee has rightly questioned the regulators about the adverse impact that the pending proposal will have on eligible borrowers and small banks. One of the most significant problems in the proposed rule is a unique proposal by U.S. banking regulators to 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 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 final rule should continue the current treatment of private MI and permit banks to offset some of their capital with that of a qualified private MI, as this will significantly increase credit availability for first-time buyers 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 this week, 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 taking steps to improve the agency's financial position.

In examining the range of reforms before the Committee, I urge you to:

- Authorize risk-sharing between private MIs 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 as was recommended in the Administration's February 2011 white paper on housing finance reform, 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; and

- Encourage regulators to provide parity for private MI and the FHA in pending rules, including the QRM and Basel III.