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Housing and Insurance Subcommittee
of the Committee on Financial Services
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Hearing On "Sustainable Housing Finance: Perspectives on Reforming FHA"

Adolfo Marzol
Vice Chairman
Essent Guaranty, Inc.

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Introduction

Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, I am Adolfo Marzol, Vice Chairman of Essent Guaranty, a private mortgage insurance ("MI") company founded in 2008. Thank you for the opportunity to testify today on "Sustainable Housing Finance: Perspectives on Reforming FHA."

Let me briefly introduce myself and Essent.

I was born in Cuba and my parents came to the U.S. as Cuban refugees when I was one year old. My parents purchased their first home here with an FHA loan, and my mother still lives in that same home nearly 45 years later. About 20 years later, I purchased my first home through a Fannie Mae loan with a 5% down payment, with private MI, <u>of course</u>. My family's story is just another example of how safe, affordable and sustainable mortgage financing plays a vital role in our society by enabling homeownership. Today I represent Essent Guaranty, a company dedicated to prudently extending mortgage credit to low down payment borrowers through the issuance of private mortgage insurance.

Essent was formed in 2008, founded by private investors with a fundamental belief that private capital would be needed to support a well-functioning U.S. housing finance system in the wake of the financial and mortgage crisis. In Essent's early days, with no end in sight to the crisis, many questioned the wisdom of starting a new private MI company. Essent continued to believe that a private mortgage insurer with the financial strength to pay claims backed by a strong contract that treats policyholders with fairness and transparency would be a valued partner to lenders, mortgage investors and taxpayers (through their ownership and backstop of the GSEs).

Essent not only initiated a new wave of private capital into the MI industry, but also contributed to the renewal of the MI product by addressing market concerns related to representation and warranties in the mortgage transaction. Our introduction of Clarity of Coverage®, a binding endorsement to the company's insurance contract, commits us to the highest standards of transparent, reliable and fair practices in MI protection, and gives insured lenders and policy beneficiaries a renewed confidence that their claims will be evaluated fairly and valid claims will be timely paid. The clarity we've brought to the MI contract has been complemented by clarification of representation and warranty obligations by the GSEs and in recent contract changes by other MI companies. Clarity of Coverage shows how private sector competition can lead a broad response to market needs.

Essent's business approach has been validated by the market. Since writing our first policy in the second quarter of 2010, we have insured $19 billion in mortgage loans. Essent writes about 10% of the new private mortgage insurance in our nation, and is doing business with hundreds of lenders, large and small, across the entire country. We continue to put our capital base steadily to work bringing private credit risk-bearing capacity to the U.S. mortgage market.

We recognize the contributions of FHA to getting the nation through the recent crisis, given the contraction of private credit that occurred in the wake of the crisis, and support a future role for FHA that returns to a more focused mission of providing access to homeownership to creditworthy borrowers that cannot be adequately served in the conventional market with private

MI. Accordingly, this requires private capital to play a larger role to ensure that creditworthy borrowers continue to be well served in the U.S. mortgage market, and private capital has firmly demonstrated its willingness to invest in the U.S. MI industry. The demonstrated ability to attract capital allows firms such as ours to support the U.S. mortgage market with increasing capacity to write more, deeper and broader MI coverage.

Reform of the housing finance system, including FHA, should move forward, guided by shared objectives which should include reducing taxpayer credit risk and expanding the role of private capital, while preserving access to homeownership for creditworthy borrowers. This can best be achieved, in our view, by (i) addressing the solvency of FHA within a mission-focused footprint (ii) leveling the playing field between private MI and FHA, including encouraging regulators to establish rules such as QM (for FHA), QRM and Basel III that do not distort the market in favor of FHA (and the associated taxpayer risk) and (iii) implementing other reforms that encourage the expanded use of private capital, including MI, without adverse impacts on credit availability and liquidity in the mortgage market. For example, credit risk-sharing by both the GSEs and the FHA with private MI can play a significant role toward accomplishing these objectives efficiently and reliably.

The Role of the U.S. MI Industry

The role of private MI is important because the potential for severe credit losses is inherent in the mortgage market at all times. Protecting policyholders by absorbing insured losses, especially when economic conditions are bad, is our fundamental role. Over the past four years, private MIs have paid approximately $35 billion in claims to the GSEs, losses that would have otherwise fallen on the U.S. taxpayer. Private MIs are projected to pay a total of approximately $50 billion to cover losses arising from the downturn. This is a success story, despite the fact that three MIs went into runoff because of losses. (Runoff means the insurer is no longer writing new insurance, but continues to pay claims under regulatory supervision). Also during the housing crisis no TARP programs were created for the MI industry and no expectations exist that MI companies will be bailed out in the next crisis. The industry is firmly private without the benefit of any government guarantees – explicit or implicit.

In the crisis, the role of the industry contracted, bottoming around 2010 when new MI written fell to 4-5% of the total mortgage originations market. Since that time, new insurance volumes have grown, rising to $175 billion (including HARP refinances) in 2012, about 9.5% of mortgage originations. This remains well below a more normal MI share of the market, historically in the range of 12-15% of mortgages originated. Despite the recent lean years, the industry continues to play a meaningful role in the overall mortgage market, with total insured loan balances of $714 billion at the end of 2012. [1]

Our industry has shown resilience, importantly demonstrating the ability to attract capital, both through new entrants and recapitalization of incumbent companies. Companies in the MI industry raised over $10 billion in new capital throughout the mortgage crisis. Two incumbent companies raised nearly $2 billion this year. With the addition of new entrants, the MI industry will have about the same number of national providers going forward as it did before the crisis. Investor interest in providing capital to the U.S. MI industry appears to be quite strong. The private MI industry continues to represent private capital actively at work in the U.S. mortgage

[1] *Inside Mortgage Finance* (February 28, 2013), and Essent estimates.

market mitigating credit risk for private investors and taxpayers every day on low down payment borrowers, and can do more.

MI coverage significantly reduces the credit risk to taxpayers on loans securitized through the GSE TBA market. For example, on the typical 5% down payment loan (i.e., a 95% LTV), first-loss MI coverage insures 30% of the loan balance, transforming the risk exposure for taxpayers to an effective LTV of approximately 67%. There is a tremendous difference in loss exposure between a mortgage that defaults at 95% LTV without MI, versus the same loan with MI. That risk reduction comes from the private capital of the MI company standing in front of the U.S. taxpayer.

One of the powerful features of private MI is its effective integration in the routine functioning of the mortgage market, including TBA-securitization. Lenders of all sizes and types can access private MI and secure the coverage at loan origination, reducing the credit risk on the loans before taxpayers backstop the risk. MI also works effectively with lenders and GSEs in the servicing of mortgage loans, including significant delegation of authority to servicers and GSEs to undertake modifications to keep families in homes or to benefit from foreclosure alternatives, such as short sales.

Expanded Role of Private MI In Housing Finance Reform

As Congress considers the path of housing finance reform, and the role of FHA within the future system, no question seems to be more fundamental than defining the relative roles of the private sector and government in the market. There is widespread agreement that the role of private capital should be expanded and taxpayer exposure to mortgage risk reduced from its present state.

Many discussions of reducing the role of government rest on the premise that the choice is one of no taxpayer credit risk or all taxpayer credit risk. Framed in this context, reform discussions have paid great attention to the return of the fully private securitization market without an explicit or implicit government backstop. These markets are, in fact, slowly re-emerging after being moribund since closing for newly originated loans late in 2007. The return of a purely private securitization market should enjoy bipartisan support because, at a minimum, these markets will be needed to play an important role in serving jumbo borrowers.

However, a robust return of private capital and reduction of taxpayer risk need not wait for the return to vitality of purely private securitization markets. In those sectors where government provides a backstop, the expanded use of private MI and similarly well-capitalized and regulated private credit enhancements provide a powerful tool to significantly reduce taxpayer risk.

Use of private MI and other private credit enhancements to place private capital ahead of taxpayer risk is being implemented on an expanded basis by FHFA in the conservatorship of the GSEs. The 2013 FHFA Scorecard for the GSEs established a goal of transferring credit risk to private markets on $60 billion of GSE-backed mortgages where otherwise taxpayers would be taking the predominant risk of credit loss. This FHFA-directed initiative will further validate the benefits of private capital bearing the predominant risk of loss in front of taxpayers in ways that do not disrupt borrower and lender access to TBA-securitization.

In addition, expanding the role of MI can be done gradually through a known process that works. Reforms that require sudden, "big bang" change to the roles of FHA and the GSEs are risky for borrowers and mortgage market participants alike and present Congress with complex choices and uncertain outcomes. If the change fails to work as expected, the adverse consequences will be felt across the entire economy. Transition approaches that can be sensibly paced, going quickly when private capital is abundant yet reconsidered when not achieving reform, reduce the downside risks from change. The expanded use of private MI through broader risk-sharing meets the objective of sensible pacing, taking on more risk and serving more borrowers as quickly as private capital capacity grows.

In sum, the expanded risk-sharing initiatives at the GSEs represent the most direct and efficient path to increasing private capital and reducing taxpayer risk in the housing finance system. The lessons learned from expanded credit risk-sharing by the GSEs should provide very useful insights to this Subcommittee as it considers ways to reduce government's credit risk-bearing role at both FHA and the GSEs. We encourage Congress to strongly endorse expanded use of risk sharing with private MI by the GSEs under the direction of FHFA, as well as to consider risk-sharing by FHA, as explained below.

Addressing FHA Solvency

Addressing the solvency of FHA is an important element of FHA reform. The FY2012 actuarial report analyzed the economic value of the Mutual Mortgage Insurance ("MMI") Fund and estimated a "baseline scenario" economic value of negative $13.5 billion.[2] The present and estimated future economic values of the MMI Fund place significant reliance on the contribution of new books of business. FHA Commissioner Galante's testimony on February 13th to the House Financial Services Committee emphasized the role of new business by stating, "…books of business insured through 2009 are placing a great amount of stress on the MMI Fund while those insured since 2010 are adding substantial value to the Fund…." The assumed beneficial impact of new business should be of concern for two reasons:

> First, the actual economic contribution of new business is unknown, subject to future economic conditions that may not prove to be benign. Inherent in writing mortgage insurance is the possibility that significant economic stress will occur resulting in large losses. This concern is validated directly within the FY2012 actuarial review, which provided the economic value of the MMI Fund under economic scenarios less optimistic than the baseline scenario.[3] These less optimistic economic scenarios reported in the study showed lower economic values of the MMI Fund ranging from negative $19.5 billion to as low as negative $65.4 billion.
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> Second, when new business outside of the mission of FHA contributes immediately to the solvency of the MMI Fund, there will be strong incentives working against a return of private capital, which already must overcome the significant advantages of FHA over a private MI industry that must hold real capital, pay federal and state taxes and cover operating expenses. If the policy analysis of taxpayer risk is going to be based totally on assumptions and utilize optimistic economic outlooks rather than stressful scenarios that

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[2] U.S. Dept. of Housing and Urban Development, *Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund* (November 2012), Exhibit IV-13 at pg. 47 (forward loans only).
[3] Ibid (forward loans only).

more accurately reflect the inherent risk, the analysis will make privatization of risk unattractive compared to continued nationalization of the risk.

The issue of FHA solvency has been a focus of Congress and the Administration, along with the broader questions of long term housing finance reform. Much is being done to restore the fiscal condition of the MMI Fund and HUD Secretary Donovan and FHA Commissioner Galante should be commended for the actions taken to date to raise premiums and strengthen the financial condition of FHA. We support further steps to address solvency of the FHA MMI Fund on the basis of FHA maintaining a proper, mission-focused business footprint, including:

- Enacting provisions similar to those adopted by the House last Congress in H.R. 4264 "The FHA Emergency Fiscal Solvency Act of 2012";
- Additional authorities HUD has requested to address solvency; and,
- Prudential changes to seller concessions, a policy change HUD has proposed but not implemented.

The Future of FHA and Private MI: A Partnership to Serve the Market

The current structure of the mortgage market often pits private MI and FHA against each other as competitors. The structure results in borrowers who could become home owners by qualifying for private MI to end up in FHA. The FY2012 Actuarial Review reported that over 95% of 2012 FHA loans had LTV's below 97% and 57.5% of all loans had credit scores of 680 or higher.[4] Essent's credit guidelines, and MI industry guidelines generally, extend to LTVs of 97% and credit scores of 680 and above. This data suggests that a meaningful portion of FHA borrowers may qualify for private MI, a conclusion supported by an observed shift in market share for insured loans toward private MI since FHA implemented additional premium increases in April of 2012. In the first quarter of 2012, prior to the FHA premium increases, the private MI share of the insured market was approximately 26%, and rose during the remainder of 2012 to 34.5% in the fourth quarter.[5]

These recent shifts in the market represent progress in returning to a more normal balance of public and private. To sustain the progress, it is important to do more to create a level playing field for private MI. At prior hearings, factors which advantage FHA over private MI were the subject of detailed testimony, including that FHA offers credit terms to all borrowers beyond those allowable in conventional markets (e.g., 6% seller concessions) and that FHA enjoys access to full faith and credit securitization of Ginnie Mae (whereas private MI, being securitized through GSE MBS, does not). Prospective regulations, such as FHA developing its own QM definition, the forthcoming final definition for QRM, and the currently proposed Basel III capital rules for banks, depending on their outcome, could create incentives for lenders and banks to use FHA, even though borrowers could be served at the same or a lower price by private MI. Reforms that can create a more level playing field for private MI will help continue to expand the role of private capital and reduce the need to call on taxpayers to bear the risk of such a large segment of the market.

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[4] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012, November 5, 2012. See Exhibit IV-5 for LTV distribution and IV-6 for Credit Score (Percentage of Fully Underwritten FHA-Insured Mortgages by Dollar Volume).

[5] "Primary Mortgage Insurance Activity" *Inside Mortgage Finance* (February 28, 2013).

As opposed to competition between FHA and private MI, a better approach is greater partnership between private MI and FHA. In a partnership model, the two types of insurance, private and public, would work together to ensure coverage of the market built on the principle that private should be preferred to public when private can serve borrowers well. In such an approach, the future role of FHA would more naturally expand or contract based on the robustness of the risk tolerance and capacity of private mortgage insurance providers.

The ultimate goal should be a well-functioning market that dynamically adjusts so private risk bearing is as large as possible and public risk bearing is as small as possible, without gaps in the credit access of mortgage-ready borrowers. FHA Commissioner Galante in her testimony to the House Financial Services Committee on February 13th of this year importantly testified that, "By design, FHA's programs are meant to complement, not supplant, private capital." She further stated that FHA should, "…step back when private capital returns or expands to serve previously underserved populations." Essent's partnership approach to private MI and FHA is consistent with the Commissioner's statements. Such an approach can help address concerns with well-intended reforms meant to encourage private capital that could inadvertently have an adverse effect on ready borrowers.

FHA Risk-Sharing with Private MI

If the partnership approach is one Congress considers worthy of exploration, credit risk-sharing between FHA and private MI would be a logical initiative to pursue because credit risk-sharing could be designed to place private capital in a first loss position ahead of taxpayer exposure, placing taxpayers in a more remote risk of loss. There are some broad alternative approaches to risk-sharing we propose for consideration:

1) **Reinsurance** - One approach to risk-sharing would be direct risk-sharing between FHA and private MI, analogous to how the GSEs are moving forward in their expanded risk-sharing initiative. This approach has the benefit of minimizing impacts on primary market participants and has the potential to be implemented more quickly.

2) **Coinsurance** - A second approach to risk-sharing would combine MI and FHA risk-sharing with the objective of deploying the risk management capabilities of MI companies in loan underwriting and claims management. This is analogous to how private MIs work today with the GSEs for new loans with LTVs above 80% that require MI, where borrowers must meet underwriting and eligibility criteria acceptable to both the GSEs and private MI.

The necessary details of the risk-sharing approaches above should be developed and tested through risk-sharing pilots. Much could be learned from pursuit of such pilots, including: (1) which FHA loans are, in fact, privately insurable risks, (2) more robust identification of the reasons FHA loans are not eligible for private coverage, (3) differences between FHA practices from those acceptable in the private market, (4) private versus FHA pricing for risk, and (5) any unintended adverse impacts on borrowers or lenders. This learning could inform more permanent reforms, in conjunction with an assessment of the risk-reducing benefits for taxpayers, appropriately evaluated under the assumption of stressful economic conditions including a material decline in home prices.

To move forward in this direction requires Congress to revise existing statutory authority for FHA to engage in such risk-sharing pilots and to signal a clear desire to see FHA work with private industry to move this forward. Given that FHFA is targeting $30 billion in loans to be included in risk-sharing transactions by each GSE in 2013, consideration should be given to setting a similar target for FHA risk-sharing pilots.

Conclusion

Private investors have demonstrated their interest in investing capital to support the U.S. mortgage market through the private MI industry, enabling the industry to continue to serve low down payment borrowers to achieve homeownership and play a broader risk-bearing role. Accordingly, we support a continued future role for FHA which transitions to a more focused mission of providing access to homeownership to creditworthy borrowers who cannot be adequately served in the conventional market with private MI. In addition, the expanded use of MI by the GSEs in the risk-sharing initiatives announced by FHFA shows that the industry can play an even broader role in bearing credit risk and reducing taxpayer exposure to credit risk.

Reform of the housing finance system should be implemented, including reform of FHA. Changes should be implemented gradually so as not to disrupt a large and vital market. We should find common cause in sound objectives for reform - to reduce taxpayer credit risk, and expand the role of private capital but preserve access to homeownership for creditworthy borrowers. In this regard, we urge the Congress to support:

- Changes aimed at addressing the solvency of FHA within a mission-focused footprint;

- Creating a level playing field between private MI and FHA so that risk does not go needlessly to taxpayers when credit risks are privately insurable. This includes encouraging regulators to establish rules such as QM (for FHA), QRM and Basel III that do not distort the market in favor of taxpayer-backed risk;

- Expanding use of private MI to gradually broaden the role of private capital without adverse impacts on liquidity in the mortgage market. In this context, we specifically encourage consideration of working toward a new, partnership approach between private MI and FHA that moves the market toward that largest role possible for private risk bearing without loss of mortgage access by creditworthy borrowers.

- Testing the potential to expand the role of private capital through risk-sharing pilots by FHA using private MI for privately insurable risk.