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Hearing on
Future of Housing Finance: The Role of Private Mortgage Insurance
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Good morning Chairman Kanjorski, Ranking Member Garrett and members of the subcommittee. I am Janneke Ratcliffe, associate director for the Center for Community Capital at the University of North Carolina at Chapel Hill and also a Senior Research Fellow in Housing Policy at the Center for American Progress Action Fund.

I am honored to have the opportunity to share some thoughts on the future of the housing finance system, in particular, the role of private mortgage insurance. Your inquiry sheds light on an important, but often obscure, part of the mortgage business. Private mortgage insurance has long played an important role in facilitating home ownership, and has recently provided an element of stability to the market. An examination of this particular industry holds lessons that can inform the overall mortgage finance system.

The importance of high loan-to-value lending

A discussion about the role of mortgage insurance must begin by stressing the importance of giving families the opportunity to buy homes when they do not have enough accumulated wealth to make a big down payment, which is what primary mortgage insurance exists to do. This is not about speculative, “no money down” schemes; this is about the first step to building family economic security and realizing the long-term benefits of homeownership. Surely many of us and our family members have started up the homeownership ladder with a modest down payment and a loan made possible because of some form of mortgage insurance: be it private mortgage insurance, Federal Housing Administration (FHA) insurance, or the Veteran Affairs (VA) program for servicemen and women. I, for one, relied on private mortgage insurance to buy my first home.

Access to this type of financing is critically important because home ownership continues to be the cornerstone of household wealth in the United States. At a macro level, real estate holdings comprise the largest element of household assets in the United States.¹ Its value to individual families is equally profound, and increases as you go down the income spectrum, with home equity comprising more than three quarters of the wealth of low-income families.² Among families earning between \$20,000 and \$50,000, those who own homes have 19 times the wealth of those who rent.³

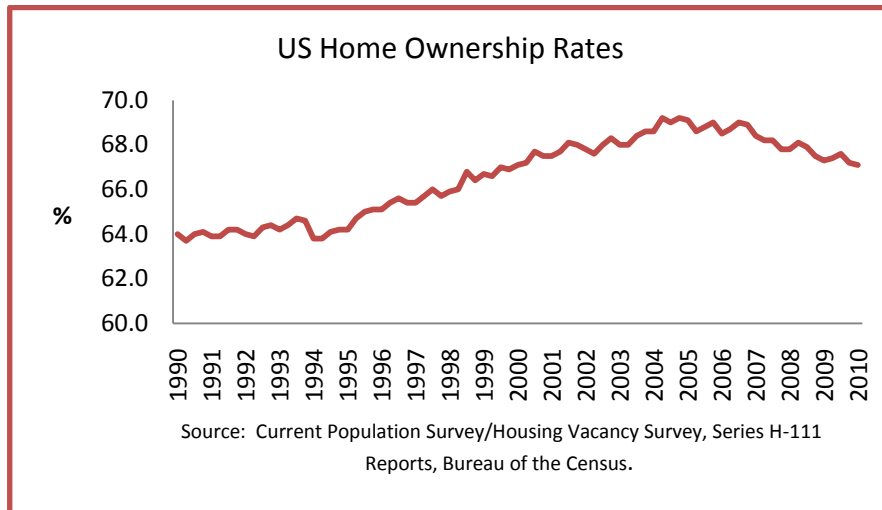
Homeownership continues to be one of the best potential answers to the persistent racial wealth gap. The median wealth of black families is a fraction of that of the median white family (\$5,000 vs. \$100,000, respectively as of 2007).⁴ This gap is echoed in homeownership rates: As of the end of 2009, roughly 72 percent of white households owned their own homes, less than half of African-American and Hispanic households owned theirs. Among Hispanic and Black households, owners have 39 and 85 times the wealth of renters, respectively.⁵

Historically, and even today, as a leveraged investment, (with even modest appreciation and a built-in savings mechanism), homeownership represents the best way for households to build wealth and long-term assets. However, this requires access to responsible financing, which can be barred by income, credit, and asset requirements that either lock people out of the market, or leave them open to higher-cost lenders. We have long recognized that among those three primary constraints, reducing the down payment barrier is the best way to increase ownership opportunity for more low-income or minority households.⁶ The median sales price of a single-family home in the US in 2009 was \$172,100;⁷ making a 20 percent down payment required \$34,420 in assets, greater than the entire annual income of roughly a third of all U.S. households.⁸

In the average year, of all the home mortgages made, nearly one-third are to families with less than 20 percent equity, and among these are families who will later buy another house, perhaps yours or mine.

There is a right way to do high loan-to-value lending

It is well understood that low equity is associated with higher risks; if a borrower with little home equity loses their job, for example, they cannot easily sell the house to pay off the mortgage. This basic understanding is part of why FHA/VA insurance was developed, why the government sponsored enterprises charter requires certain other forms of credit enhancement to buy loans with loan-to-value above 80 percent, and why banks are required to hold more capital for the higher loan-to-value mortgages they hold. Even in the wake of the foreclosure crisis, we have evidence that this risk can be managed through financing that has enabled hundreds of thousands of working families with modest incomes to become successful homeowners. This was accomplished not through exotic mortgages that created only an illusion of homeownership, but through consumer-centric policies and practices that removed barriers to homeownership for first-time, minority and low-income families, responsibly. These programs did not develop out of financially engineered sleight of hand that failed to account for risk. They evolved through decades of careful innovation, such as Community Reinvestment Act lending programs, new approaches introduced by the MI companies and GSEs, adjustments to underwriting guidelines, pre-purchase counseling, and down payment assistance programs.⁹ These efforts paid off in a steady increase in homeownership rates between 1995 through their peak in 2004. Note that the subprime boom was just getting into full swing then, and that during the peak years in 2004 – 2007, homeownership rates actually leveled off and started to decline through the foreclosure crisis.



One example of what we know about the right way to finance affordable homeownership is the Community Advantage Program, or CAP. Launched in 1998, by Self-Help in partnership with Fannie Mae and the Ford Foundation, this program has funded more than 50,000 mortgages nationwide. The median borrower earned \$33,000; about forty percent of the mortgages are to single female-headed households, and about forty percent are to minority borrowers. The risk profile of these mortgages looks daunting, especially by today's standards: 44 percent had a Fair Issac & Company score at origination of 660 or less and 90 percent of the borrowers put down less than 10 percent, including 69 percent who put down less than 5 percent. Yet to date, fewer than 4 percent of the loans have ended in foreclosure, The CAP borrowers received fixed-rate, thirty-year, amortizing mortgages at prime-market pricing, fully underwritten by the originating lenders following guidelines approved by Self-Help. Our research found that borrowers who received a subprime loan were three to five times as likely to default as CAP borrowers with the same risk profile.¹⁰ Meanwhile, the median CAP owner accumulated more than \$20,000 in equity through the end of 2009, more than she would have earned following the Dow Jones Industrial Average and, when you consider the modest equity investment made, that represents a double digit return on investment annually. CAP demonstrates that high loan-to-value lending makes sense for lenders and for households, when done right.

Why the private primary mortgage insurance model works

The private mortgage insurance model provides, on a much larger scale, another answer as to the right way to support high loan-to-value lending. An industry built on insuring mortgages with low down payments has weathered the mortgage crisis, paid substantial claims without any federal support, and even managed to attract new capital.

In simple terms, private primary¹¹ mortgage insurance is required by many investors and lenders when funding higher loan-to-value mortgages. It covers the amount of the loan that is above some threshold percentage of the value of the property, and puts the mortgage insurer in first loss position.¹² In the event of default, after being paid by the insurer, the lender/investor can expect to recover much, if not all, of the remaining balance from sale of the property. The lender/investor is the beneficiary, however, the insurance is typically paid for by the borrower as part of their monthly mortgage payment. Traditionally, mortgage insurance premiums vary by loan-to-value and a few other factors.¹³ Private mortgage insurance rates must be filed with and approved by state insurance regulators.

The mortgage insurance industry only insures a portion of the high loan-to-value, single family mortgages made in the US.¹⁴ These loans can also be facilitated through FHA/VA/Ginnie Mae, banks making high loan-to-value mortgages without insurance, or lenders securitizing them through private-label securities, which theoretically would be structured to absorb all default risks including those associated with low equity. Another mechanism that was particularly popular in the mid 2000's was the combination of an 80 percent first mortgage with a purchase money second lien for 10 percent to 20 percent. These second liens can be retained by the originating lender (typically depositories), or securitized along with the first lien. But unlike MI, in the last few years, many of the alternatives have fallen short or required direct or indirect taxpayer support.¹⁵

1. Regulated institutions with countercyclical capital at risk

Mortgage insurance rates are relatively static. Mortgage insurers must obtain state regulator approval to change rates in many states and this can be a slow process. More importantly, state regulators mandate high capital and reserving requirements, which imposes a natural price floor.

By contrast, during the build up of the mortgage bubble, less regulated, alternative sources of credit enhancement became increasingly cheap relative to the institutional monoline sources (primary mortgage insurance and FHA insurance). While FHA holds a record high market share today (21 percent for 2009), at the height of the subprime boom (2005 and 2006), FHA share dwindled to a mere 2.6 percent, and that of private mortgage insurer's likewise fell below 9 percent to a long-term low.¹⁶

On the other hand, because of regulatory and GSE requirements, the mortgage insurance companies had a decent level of reserves heading into the crisis. While they are paying a huge amount of claims—including an estimated \$30 billion to Fannie Mae and Freddie Mac that directly offsets taxpayer exposure—they point to their countercyclical capital requirements as key to their value in a volatile industry, and the reason they have not required public capital or support.¹⁸ In the overheated markets leading up to the mortgage crisis, lack of consistent oversight enabled risk to be laid off where low or no capital requirements existed. At the time this looked like innovation, but in hindsight it was recklessness. The lesson learned is that an effective and responsible mortgage finance system must consider total system capital at risk on each loan and inhibit capital arbitrage.

2. Standards

Another virtue of the mortgage insurance industry is its expertise in setting risk standards. As an industry that understands the risks and invests capital, it has an important role in developing underwriting and product standards. We now are all too familiar with how the underwriting rule book was thrown out the window with such products as option arms and stated income loans. On the other hand, mortgage insurance companies with their institutional knowledge of high loan to value lending engendered a better understanding of the true risks posed and how to mitigate them. Moreover, with their own capital at risk, they live or die by whether they get the standards right.

This issue of standards also applies to loss mitigation. Because foreclosure is likely to be the most costly outcome for the mortgage insurer, the insurer's interest is often aligned with keeping the borrower in the home. And because the mortgage insurer bears the first loss in event of foreclosure, they hold some sway in establishing delinquent loan management standards. Historically, they have been innovators in developing foreclosure avoidance strategies.

3. Risk pooling and management of specialized risks

A third virtue of the mortgage insurance industry lies in its role as a pooler of risk. For example, if you want a group of lenders to be able to withstand losses to some statistically derived level based on historical experience (say 8 percent), then each institution is required to hold 8 percent capital against their loans. Theoretically that makes sense, but in reality, only some of the portfolios will get into trouble and these will lose more than they reserved and will fail, while the others will over-reserve. But to prevent ANY failures, each lender would have to hold more than 8 percent, which would be more costly and inefficient. Instead, when risks are transferred, a few mortgage insurance companies can absorb losses from the high-loss lenders using surpluses generated by the low-loss lenders and the overall capital required to assure systemic soundness is reduced. This is a basic principal of insurance.

Pooling risk also has benefits when applied across geographic regions of the country, or across individual securities. This also works across time, as demonstrated by the fact that mortgage insurers set aside capital in the good years to draw upon in the lean. The alternative is pro-cyclical, serving to amplify volatility. For example, in 2004, expectation of high appreciation led other market participants to under price risk, thus encouraging excessive risk taking. But mortgages have a long cycle and big risk tails. When the market turned, much of the market for credit enhancement froze, exacerbating the ensuing downturn.

The same principal applies across market segments. If the market penalizes underserved groups and communities by limiting access to capital, or by targeting them with costly and risky products, it reinforces weakness in those segments. Here, mortgage insurance differs from other kinds of insurance. Paying high auto insurance premiums does not increase one's likelihood of having an accident. However, mortgage borrowers who are charged high rates find it harder to make payments and, in communities where credit is more costly, property values are likely to be weighed down.

The mortgage insurance companies, and for that matter Fannie and Freddie, smooth out and pool mortgage risks across time and across securities, lenders, regions, and borrowers. Thus they provide more consistent access to financing, ideally in a manner that does not overheat strong markets and worsen weak markets.

Implications

A regulatory success story

These days, we hear a lot about regulatory failures, but mortgage insurance is one story of regulatory success. At a centralized level, the GSE's (and their regulator and counterparty risk requirements) set de facto regulations. At the same time, the role of state insurance regulators is vital to the outcomes we are discussing today. Among these regulatory mechanisms, the higher standard generally prevails, thus preventing regulatory arbitrage. This regime stands in stark contrast to that of the broader mortgage market, where federal preemption and regulatory gaps allowed lenders to go around the rules.¹⁷

The evidence strongly suggests that the state regulatory system, combined with a federal oversight role, led to systemic safety and soundness, at least within the privately-insured market, and that its principal elements should be preserved.

The need to ensure broad access

Justifiably, private mortgage insurance has special consideration in the GSE charter and as a "qualified residential mortgage" factor that can offset risk retention requirements.

This special consideration has implications, as the mortgage insurance industry will play a central role in determining who gets access to homeownership. In the past, mortgage insurance companies have shown leadership in developing products that enabled the GSEs to expand their affordable housing lending. But we face even bigger challenges today.

If anything, barriers to homeownership are growing, as are the gaps. It is estimated that among families who owned their homes in 2006, 7 percent of non-Hispanic white households have lost their homes or are expected to. While this number is disturbing, an even greater proportion of African-American families (11 percent) and Latino households (17 percent) are in the same situation, disproportionately wiping out family wealth.¹⁸ For example, we found that among 25 foreclosed Latino families surveyed, the average wealth loss was \$90,000.¹⁹

To make matters worse, these problems are not randomly distributed, but geographically concentrated. Entire communities have been impacted by wealth-stripping predatory lending, high cost subprime loans, and now, defaults. Looking beyond the crisis, it is reasonable to expect that access to prime credit in these communities is likely to remain scarce, due to weak appraisals and other neighborhood conditions classified as “risky.”

Unfortunately, income losses from the recession are also disproportionately affecting minorities. For example, the median income for black families has fallen from 65 percent of that of white families in 2000 to 61.6 percent in 2008, and the African-American unemployment rate is currently nearly double that of whites.

Further, the loss of homes, wealth and income will impact credit scores for years to come. Thus we are facing a perfect storm where all three of the key constraints to homeownership—down payment, income, and credit—are tightening and putting homeownership further out of reach. As prime credit options shrink we are likely to see a re-widening of the homeownership gap between the haves and have-nots. Rebuilding our hardest hit communities will require the affirmative involvement of all market participants.

Today is for retrenching. Underwriting guidelines are justifiably conservative. But we must make sure that the pendulum hasn't swung too far and that we are able to accurately distinguish real risks from perceived risks going forward. To that end, mortgage insurers must also be held accountable to public policy goals of enabling access to safe mortgage products.

This caveat applies not just to underwriting, but also to pricing as well. Mortgage insurance embeds a basic level of risk-based pricing: borrowers with less money down have to buy an insurance product. Currently, Fannie and Freddie and the mortgage insurers may add a number of price adjustments based on characteristics of borrowers, properties, and/or weaker markets. The cumulative result runs the risk of replicating subprime pricing while lacking transparency to the borrower. Two of the key lessons that we should carry forward from the financial crisis are the importance of transparency in pricing, and the fact that adding costs to more vulnerable borrowers or those in weaker markets can actually contribute to weaker performance.

Further, how can one judge risk in markets that are *underserved*? As we have shown from the CAP program, expanding access to safe and affordable mortgage products with careful underwriting can support profitable lending to populations otherwise perceived to be high risk. In fact, the mortgage programs lenders used to originate CAP loans were not to GSE standards and most of the loans did not have mortgage insurance.

What am I suggesting? Perhaps some kind of public purpose role for mortgage insurers, or some provisions included in secondary market reform. For example, a proposal by the Mortgage Finance

Working Group²⁰ lays out a framework for a “Housing Innovation Finance Fund.” Through partnerships between public and private providers, the fund would find new ways to expand mortgage access to underserved markets.

In conclusion, when done right, high loan-to-value mortgages are essential for the US housing system to offer opportunities and a pathway to the middle class. Mortgage insurance brings significant value to the industry by deploying private capital while conducting safe and sustainable high loan-to-value lending. Principals that contribute to their value include: long term countercyclical capital, proven standards for safe and sound lending, and pooled risk. The overlay of state regulation and federal oversight has played a critical role in maintaining systemic stability within this industry.

Going forward, private primary mortgage insurance should have an important role in the market. At the same time three key provisos should be observed: First, policy makers should see that a level regulatory playing field is maintained, one that considers long-term system-wide risk taking capacity and avoids a race to the bottom. Second, mortgage insurers (among others) must be held accountable through balanced and transparent pricing, leadership in foreclosure prevention, and providing broad access to good loans. Finally, alternatives should be cultivated to foster innovation and increased access to safe mortgages for underserved markets.

Thank you for the opportunity to testify this afternoon. I would be happy to answer any questions.

¹ Board of Governors of the Federal Reserve, “Balance Sheet of Households and Nonprofit Organizations” (2010) available at <http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf>

² Di, Zhu Xiaou “Housing Wealth and Household Net Wealth in the United States: A New Profile Based on the Recently Released 2001 SCF Data” (Cambridge: Joint Center for Housing Studies, Harvard University, 2003).

³ Joint Center for Housing Studies, Harvard University, “State of the Nation’s Housing 2009; Appendix W-5” (2009).

⁴ Thomas M. Shapiro, Tatjana Meschede, and Laura Sullivan, “The Racial Wealth Gap Increases Fourfold.” (Waltham: Institute on Assets and Social Policy, 2010).

⁵ Joint Center for Housing Studies, Harvard University, “State of the Nation’s Housing 2009; Appendix W-5” (2009).

⁶ Roberto G. Quercia, George W. McCarthy, and Susan M. Wachter “The Impacts of Affordable Lending Efforts on Homeownership Rates,” *Journal of Housing Economics* 12 (1) (2003): 29-59.

⁷ National Association of Realtors®

⁸ U.S. Census Bureau 2010 Statistical Abstract. 35.5 percent of U.S. households earned less than \$35,000 (2007 dollars).

⁹ David Abromowitz and Janneke Ratcliffe, “Homeownership Done Right: What Experience and Research Teach Us,” (Washington: Center for American Progress, 2010).

¹⁰ Lei Ding and others, “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Matching,” (Journal of Real Estate Research, forthcoming).

¹¹ These comments do not deal with several ancillary issues related to this industry such as pool insurance and reinsurance that ultimately bear further discussion. It focuses on the traditional, loan-level, primary mortgage insurance product.

¹² In a stylized example, where a borrower is buying a \$100,000 home with a 5 percent down payment and the lender wants to be exposed to no more than 75 percent of value, the borrower will be

required to purchase mortgage insurance for 20 percent of the loan (\$95,000 – \$75,000), which is restated as 27 percent of the loan. In the event of default, the insurer will pay the investor 27 percent of the outstanding loan balance plus qualified expenses.

- ¹³ MI premiums most commonly run from 0.3 percent to 1.9 percent of the loan amount per annum. By comparison, FHA insurance typically costs 2.25 percent up front and 0.55 percent annually for the highest LTV bucket. Examples of typical MI premiums can be found on websites of the companies, such as http://www.pmi-us.com/media/pdf/rates/pmi_monthlynumonthly.pdf; http://www.mgic.com/pdfs/71-61210_natl_bpmi_monthlies.pdf; and <https://www.ugcorp.com/rates/043010/Borrower-PaidMonthly.pdf>. FHA premium information is available at Holden Lewis, “FHA Loan Costs to Increase,” *Bankrate.com*, January 25, 2010, available at <http://www.bankrate.com/finance/mortgages/fha-loan-costs-to-increase.aspx>.
- ¹⁴ Hutchinson, Suzanne, Mortgage Insurance Companies of America. Letter re: request for comments on reform of the housing finance system. July 21, 2010.
<http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b1e23a>.
- ¹⁵ FHA insurance is by definition a form of public support. However, FHA is a self-funding agency.
- ¹⁶ *Inside Mortgage Finance*, 27 (6) (2010); Federal Housing Finance Administration, “State of the Private Mortgage Insurance Industry: Implications for U.S. Mortgage Markets and the Enterprises” (2009), available at http://fhfa.gov/Default.aspx/webfiles/14779/MMNOTE_09-04%5B1%5D.pdf.
- ¹⁸ Hutchinson, Suzanne, Mortgage Insurance Companies of America. Letter re: request for comments on reform of the housing finance system. July 21, 2010.
<http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b1e23a>
- ¹⁷ See our related research on state antipredatory lending laws and the effects of federal preemption at <http://www.ccc.unc.edu/abstracts/preemptionEffect.php>.
- ¹⁸ Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, “Foreclosures by Race and Ethnicity: The Demographics of a Crisis,” (Oakland: Center for Responsible Lending, 2010).
- ¹⁹ Janis Bowdler, Roberto Quercia, and David Smith, “The Foreclosure Generation: The Long Term Impact of the Housing Crisis on Latino Children and Families,” (Washington: The National Council on La Raza, 2010).
- ²⁰ See http://www.americanprogress.org/issues/2009/12/housing_finance.html.