**Statement of William A. Simpson Vice President,**
**Mortgage Insurance Companies of America**
**Before the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy**
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I am William A. Simpson, Chairman of Republic Mortgage Insurance Company, headquartered in Winston Salem, North Carolina and Vice President of the Mortgage Insurance Companies of America (MICA), the trade association representing the mortgage insurance industry. MICA is pleased to provide you with information on the non-traditional mortgage market. In MICA's testimony I will first explain the role mortgage insurance (MI) plays in the mortgage market and then discuss data on the scope of the market for non-traditional mortgages. Finally I will discuss solutions to the problems caused by non-traditional mortgages that MICA believes are important. MICA supports the pending guidance on non-traditional mortgages proposed by the bank regulatory agencies.

**The Role of Mortgage Insurance**

The mortgage insurance industry was founded in 1957. Since then we have helped over 25 million families become homeowners by enabling them to buy homes with a very little down payment.

Mortgage insurers provide credit enhancement – that is credit-risk mitigation – to ensure that lenders and investors such as the government-sponsored enterprises (GSEs) are protected in the event of borrower default. This means, in essence, that after the borrower we stand first in the line of fire on mortgage related risk. If borrowers default, we take much of the loss, ensuring that investors such as the GSEs are protected. Because of the high capital requirements and stiff regulation governing mortgage insurers, the industry is well positioned to take on this risk. Currently, the members of MICA have $635 billion of insurance in force and approximately $16.8 billion in capital.

We take a conservative view of mortgage risk because of our first loss position. However, we also have a historical perspective. We were there when the mortgage markets turned sharply down during the mid-1980s especially in the oil patch and the early 1990s in California and the Northeast. The MI industry paid approximately $15 billion in claims in the 1980s and 1990s primarily covering the losses to federally insured banks, savings association and the GSEs.

We act as review underwriters for the credit and collateral risks related to individual loans and we assess the local, regional and national economic risks that could increase mortgage defaults. This role of review underwriter not only protects the investor in the loan but the homebuyer as well. The mortgage insurer and the homebuyer share a common interest in the mortgage transaction because they both have the greatest risk of loss in the event of default. Upon default, the borrower will lose his or her home and the equity invested in it, and the mortgage insurer will incur a loss by paying a claim. Thus, the insurer and the borrower are both concerned that the home is affordable not only at the time of purchase, but throughout the years of homeownership.

## Non-traditional Mortgages

### What are non-traditional mortgages?

The usual definition of non-traditional mortgages include the following: 1)option arms where the borrower may skip a payment for any reason or not pay the full interest rate, which in both cases results in negative amortization; 2)interest only loans where the borrower only pays the interest on the loan and none of the principle for a period of time; 3)piggy back mortgages where the borrower takes a first mortgage on the property for 80 percent of its value and simultaneously takes a second mortgage on the property often for the remaining value of the property so that the borrower has no equity in the home; 4)loans with a 30 year fixed term, which are amortized over 40 years, reducing the borrower’s monthly payment but often resulting in a lump sum remaining principal payment due at the end of a defined period less than the amortization period. For these non-traditional mortgages the loan may come due in a balloon payment in just a few years and/or interest rates may reset very quickly, exposing the borrower to additional risk resulting from potentially, sharply, higher monthly payments and/or refinancing costs. 5) An increasingly large number of non-traditional loans also now come with “teaser” features (very low initial interest rates and payments) that either create “negative amortization” or large increases in loan payments too soon after the closing both of which can create defaults by the borrower.

Data on non-traditional mortgages

There is not much available data on the size, characteristics, and rate of growth of the non-traditional mortgage market. Below is some current public data from private and government sources.

- *Size of market - Inside Mortgage Finance* (July 14, 2006 edition), a mortgage industry publication, noted that data through mid-2006 shows non-traditional mortgages represent 37 percent of current originations. A July 2005 Federal Reserve Board (FRB) senior loan opinion survey found that "[m]ore than one half of respondent banks indicated that the share of nontraditional residential mortgage originations over the past twelve months was higher than it had been over the previous twelve-month period. Twelve percent of respondents noted that this share was substantially higher."

- *Interest Only (IO) Mortgages* - IO mortgages remain a significant part of the non-traditional sector. No data is available on the number or percentage of IO mortgages originated, but the *Inside Mortgage Finance* study concluded that they comprise 26 percent of private mortgage back securities issued during the first half of 2006. In testimony before this committee last week the Federal Deposit Insurance Corporation (FDIC) estimated that IO mortgages and option ARMs together appeared to make up as much as 40 to 50 percent of all loans securitized by private issuers of mortgage backed securities (MBS) during 2004 and 2005.

- *Piggyback Mortgages* - SMR, a private research firm, found that piggyback mortgages comprised 48 percent of all purchase money mortgages originated in the first half of 2005 and 38 percent of those loans had a combined loan-to-value ratio above 95 percent. Similarly, the FRB estimates that these loans accounted for 22 percent of purchase loans in 2005, up from 14 percent in 2004.

- *Option ARMs* – As noted above, the FDIC estimate suggests option ARMs combined with IOs comprise 40 percent to 50 percent of private MBS issuances. An August 2005 study by Standard and Poors concluded that about 75 percent of option ARM borrowers use negative amortization in any given month. Similarly, Bear Stearns estimated that about 65 percent of option ARM borrowers made payments that fail to cover the full amount of the interest owed and that half the option ARM borrowers make payments that result in negative amortization.

- *Characteristics of Non-traditional Market* - An August 2005 Office of the Comptroller of the Currency (OCC) survey found the first drop in overall credit underwriting standards in the eleven years the OCC had been conducting this survey. Looking specifically at the characteristics of the non-traditional market, the OCC found that “[h]igher credit limits and loan-to-value ratios, lower credit scores, lower minimum payments … less documentation and verification, and lengthening amortizations - have introduced more risk to retail portfolios.” It also noted that “[b]ecause reduced payment requirements and extended amortization arrangements can mask credit risk, bankers need to develop broader, more discerning, and more forward looking approaches to measuring and monitoring risk in retail portfolios.”

Consistent with the OCC study on the drop in credit quality is the *Inside Mortgage Finance* study mentioned above. It noted that much of the recent growth of non-traditional markets is coming from subprime borrowers with mortgages that amortize over 40 years but are payable in 30 years.

## Market Trends

What should cause concern for the mortgage industry and policy makers is the combination of the size in the non-traditional market discussed above and the concentrated positions taken in them by insured depositories as well as the softening of the housing market (i.e. house prices leveling off or declining, inventories of unsold homes growing and interest rates rising). To be sure, traditional mortgages are still among the safest forms of credit and mortgage credit risk has been a safer bet than most. However, it is not always a certain one as the serious problems evident in the 1980s and 1990s made clear. Introducing the inherent risk in non-traditional mortgages in a soft market is a recipe for another debacle like the 1980s and early 1990s. Indeed, below MICA notes factors that make emerging trends still more worrisome. These include the following:

- The FRB recently found that 33.5 percent of assets in insured depositories - $3.1 trillion – is now concentrated in real estate risk. This is significantly up from the percentages in the 1980s and 1990s and is the highest percentage concentration reported by the FRB since 1973. Many lenders have double, triple or even more of their regulatory capital committed to this asset class. This creates what the banking agencies rightly call “concentration risk.”

- Recent data released from the National Association of Realtors indicate that the volume of house sales has fallen from a year earlier and early indications are that house prices will dip in the future – if only temporarily. Other economists are forecasting reductions in regional house prices for 2007 with house prices remaining depressed for several years. The latest report from the Office of Federal Housing Enterprise Oversight (OFHEO) indicates that the average annualized increase in home prices in the second quarter of 2006 was 4.7 percent compared to 13.4 percent for all of 2005. The fact is, at this stage, no one knows for sure what will happen and for how long, but stagnant house price growth appears to be just around the corner.

MICA’s concern about the mortgage market is not limited to these troublesome warning indicators. We also fear that vulnerable consumers may not either know or understand the real terms and conditions of these increasingly complex mortgage loans. Anecdotal evidence discussed in the cover story of the September 11, 2006 issue of *Business Week* supports this as it suggests some consumers do not understand the ramifications of their non-traditional mortgage. It is critical that borrowers get the right mortgage to ensure personal financial stability over the years. Higher foreclosure rates will result in more displaced families and poor credit will set these families back years from reaching goals like college education for their children. Similarly, when foreclosure rates rise, struggling neighborhoods can become blighted ones, which puts families at risk and creates undue cost for local, state and federal government agencies.

**Solutions to the Problem**

MICA supports the work being done by the bank regulatory agencies to ensure that non-traditional mortgages do not jeopardize the financial health of insured depositories and that consumers understand the nature of the loans they receive. The bank regulators have taken two important steps to curb the risks created by non-traditional mortgages. First, in mid-2005, they issued a final guidance on second mortgages. The guidance required sound underwriting standards and effective credit-risk mitigation on second mortgages. Part of the reason the regulators released this guidance was to ensure that borrowers who received piggyback mortgages were not at risk because the combined first- and second-liens were at or above the value of the underlying home. MICA’s only complaint with the second lien guidance is that bank regulators have not adequately enforced it.

The second step the bank regulators have taken is to release a draft guidance on first mortgages which builds on the second-lien standards and addresses the broader risks posed by non-traditional mortgages. They did so in mid-December of 2005 and took the unusual step of asking for public comment on the draft. They have not yet issued a final guidance. We urge the agencies not only to quickly finalize the standards, but also to ensure that they and the prior second-lien guidance are backed by effective enforcement.

MICA supports the actions of the federal financial regulators because both the second- and first-lien guidance as proposed ensures that lenders practice prudential standards with the following features:

- *Regulatory capital will reflect real risk, including concentration risk.* It is dangerous to defer regulatory capital standards for mortgages until the Basel process is concluded in the U.S. sometime in the next few years. Current risk-based capital and leverage standards results in the holders being sharply under capitalized for their holdings in non-traditional mortgages, permitting institutions – including Fannie Mae and Freddie Mac – to look far more adequately capitalized than is actually the case.

- *Under the proposed first-lien guidance, clear, simple disclosures will be given to consumers at the time they are shopping for mortgages and again upon application.* One way to provide this disclosure would be for mortgage originators to have clear booklets or other materials that describe, compare and contrast non-traditional and traditional mortgage products over time and under various house price and interest rate scenarios. This has been done in the past with adjustable rate mortgages, where the FRB provided model disclosures. It should be done again for the broader range of non-traditional mortgages and brought quickly into the marketplace.

- *Lenders will be required to maintain appropriate prudential management standards and provide customers information on their mortgage whether the loans are held in portfolio or sold into the secondary market.* This requirement is in the proposed guidance because of the credit, legal and reputational risks associated with non-traditional mortgages. Secondary market investors also should hold sufficient capital and be subject to effective concentration risk standards to limit undue risk.

- *When piggyback loans are combined with other non-traditional features such as an interest only second lien, for example, the risk presented by this structure is significantly heightened and supervisory guidance will be stringent under the proposal.* Piggyback loans should be covered by appropriate regulatory capital requirements, concentration limits and prudential underwriting standards.

The banking agencies can govern only a limited segment of lenders. Many are outside their purview. The Federal Trade Commission (FTC) – which governs all other mortgage brokers and lenders — held a series of meetings earlier this year to evaluate the activities of entities outside the scope of the banking rules. We urge the FTC to quickly issue rules comparable to the banking agencies to ensure that all mortgage originators are under comparable standards thereby protecting all borrowers to the same degree.

MI and Non-traditional Mortgages

Historically, bank regulators have recognized the crucial role of MI and we are pleased that the proposed non-traditional guidance would continue this practice. As noted, MI puts a highly capitalized, well regulated intermediary between a lender and potential mortgage losses. Thus, banks can take on more credit risk – for example, by permitting lower down payments – when MI is in place. Importantly, MI also provides a critical underwriting discipline by putting an objective party into the lending decision. If an MI refuses to provide insurance, the lender has a sure and clear sign of the presence of unacceptable risk.

**Finalize and Enforce the Second Lien and First Lien Guidance**

Borrowers today are far more highly leveraged than they were twenty years ago on the eve of the savings and loan crisis. Never before have so many borrowers had second mortgages resulting in combined debt near the value of their home. That means that banks that hold these second mortgages – not just borrowers – bear the brunt of credit risk. We do not know what will happen in the mortgage market as house prices stagnate or decline – let alone if borrowers come under more economic stress. It is thus essential that bank regulators continue to take the most conservative view of these emerging risks to protect the deposit insurance fund. Non-bank mortgage originators should come under comparable rules to protect borrowers and the financial system more generally and OFHEO and the Federal Housing Finance Board should ensure that the government-sponsored enterprises do not take high-risk mortgages from the primary market without prudent credit risk mitigation and appropriate internal controls.