S. HRG. 113–187

HOUSING FINANCE REFORM: POWERS AND STRUCTURE OF A STRONG REGULATOR

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE CURRENT REGULATORY STRUCTURE RELATED TO THE SECONDARY MORTGAGE MARKET AND EXAMINING ISSUES RELATED TO PROPOSED REGULATORY STRUCTURES

NOVEMBER 21, 2013

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C O N T E N T S

THURSDAY, NOVEMBER 21, 2013

WITNESSES

HOUSING FINANCE REFORM: POWERS AND STRUCTURE OF A STRONG REGULATOR

THURSDAY, NOVEMBER 21, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:12 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

This hearing continues the Committee's effort to examine housing finance reform proposals. Today we will explore the current regulatory structure related to the secondary mortgage market and survey the issues related to the proposed regulatory structure in legislation.

S.1217 creates a new regulator: the Federal Mortgage Insurance Corporation, or FMIC. The new regulator would wear many hats, as the operator of the insurance fund, the regulator of the home loan banks, mutual organization, and Common Securitization Platform; and authorizer of issuers, servicers, and guarantors with regard to guaranteed mortgages.

Because the structure of the housing finance system is complex with a wide range of market participants taking part, it is critical that we have a strong, effective regulator. Any piece of legislation will need to clearly detail the structure, functions, and powers of the new regulator. This regulator will need to coordinate closely with a variety of other Federal and State regulators to be effective and have flexibility to set appropriate standards and rules. In addition, we need to consider whether the new regulator should regulate for safety and soundness, conduct exams, set capital standards, play a countercyclical role, crack down on bad actors through enforcement actions, and resolve failed institutions it regulates.

We should not forget that we have experience with a weak secondary mortgage market regulator. OFHEO was widely viewed as weak, which contributed to the problems at Fannie and Freddie, and Congress created FHFA in 2008 in response. We cannot afford to return to the days of weak regulatory oversight of the secondary mortgage market, so Congress should be clear and explicit about the responsibilities and range of tools any new regulator should have.

Today's witnesses bring a wealth of experience to this important conversation. They will outline essential tools needed by the new regulator, as well as important lessons they have learned as regulators of the Deposit Insurance Fund, insurance companies, and the secondary mortgage market.

We are all aware that housing is a key part of our Nation's economy. A well-equipped, appropriately structured regulator will provide certainty to market participants and ensure a strong and stable housing finance system that provides mortgage credit to Americans across this country.

With that, I turn to Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

Today the Committee will discuss how to best structure a strong, independent regulator with appropriate checks and balances as part of the new housing finance system. We have a broad panel of witnesses, and I thank you all for coming.

In past hearings, I have highlighted the mistakes of Fannie Mae and Freddie Mac before they were placed into conservatorship. Not only did they operate as undercapitalized companies holding just 45 cents in capital for every $100 in mortgages they guaranteed, but they acted like highly leveraged hedge funds, purchasing nearly 40 percent of the private label subprime securities at the peak of the housing bubble.

These forces culminated in a perfect storm whose cleanup cost taxpayers billions of dollars in bailouts, crushing our economy and undermining America's international standing. We must learn from these mistakes. When considering reform, we must address three pivotal issues about the new regulator.

First, how can it appropriately balance its dual role as regulator and reinsurer in a highly complex market with diverse stakeholders?

Second, what authorities and powers should be vested in the new agency to ensure it is effective without duplicating existing efforts?

Third, how should we structure the governing board so that the agency is well equipped to carry out its responsibilities on day one?

S.1217 would create the Federal Mortgage Insurance Corporation, or FMIC, as the primary regulator for taxpayer-backed mortgages. The FMIC would provide catastrophic loss insurance funded by premiums and guarantee fees on eligible mortgage securitizations. As such, it would be a hybrid between the Federal Deposit Insurance Corporation and the Federal Housing Finance Agency.

The FDIC was created as an independent Federal agency in response to the bank failures of the 1920s and early 1930s. It is comprised of a five-person board of directors with no more than three directors from the same political party.

The FDIC has survive 80 years without depositors losing a single cent of insured funds, in large part because its board is designed for long-term stability and continuity, without sudden movements or extreme policy shifts.

As the guaranteed mortgage industry will need similar stability and continuity, the new regulator should have a similar balance of views. In addition, the new regulator will serve as the principal line of defense for the taxpayers and should have a strong, clearly defined purpose. Its activities and the activities of those it regulates must result in strong underwriting standards and responsible homeownership. Any reinsurance fund, industry participant, and ensuring or mortgage or financial product must be well capitalized to insulate the taxpayers from unwarranted risk. And to adequately oversee a diverse industry and to coordinate with State and other regulators, the new agency will need superb technical expertise.

In order to accomplish all these goals, we ought to reach consensus on key principles. The new regulator should be an independent agency, resolute in its mandated and unwavering to political whims. Its leadership has to be balanced out to ensure true political independence. Its safeguards and underwriting standards must be based on qualifying standards to provide mortgages but to protect taxpayers. Its finances must be frequently examined to ensure accountability and transparency, including appropriate stress tests. And, last, the agency cannot exist in a regulatory vacuum. It must coordinate with other agencies in a holistic approach to achieve sensible regulation. Any new regulator must avoid regulatory duplication that leads to increase paperwork and regulatory burdens which increase the cost of credit while creating legal nightmares.

Adopting these principles is crucial because the agency will be tested immediately upon its creation. Some of the immediate tasks it will have to undertake include to establish rules for the structure and use of a federally insured mortgage market within perimeters set by Congress, determine approval criteria and guidelines for market participants, and set up a cooperative to ensure access for small participants in a manner that also maintains adequate taxpayer protections. Today's hearing is a good platform to discuss how best to enable this new agency to succeed.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give brief opening statements?

[No response.]

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials. I will now introduce the witnesses that are here with us today.

First, Mr. Alfred Pollard is General Counsel for the Federal Housing Finance Agency.

Ms. Diane Ellis is Director of the Division of Insurance and Research at the Federal Deposit Insurance Corporation.

Mr. Kurt Regner is assistant director of the Arizona Department of Insurance, testifying on behalf of the National Association of Insurance Commissioners.

Mr. Bart Dzivi—am I pronouncing that correctly?

Mr. DZIVI. Yes, Senator.

Chairman JOHNSON. He is chief executive officer of the Dzivi Law Firm.

Mr. Robert Couch is counsel at Bradley Arant Boult Cummings, LLP, testifying on behalf of the Bipartisan Policy Center Housing Commission.

And Mr. Paul Leonard is senior vice president of Government affairs, Housing Policy Council of the Financial Services Roundtable.

We welcome you all here today and thank you for your time. Mr. Pollard, you may begin your testimony.

STATEMENT OF ALFRED M. POLLARD, GENERAL COUNSEL, FEDERAL HOUSING FINANCE AGENCY

Mr. POLLARD. Thank you, Mr. Chairman, Ranking Member Crapo, and Members of the Committee. I appreciate the invitation to testify on the powers and structure of a regulator for a revised housing finance system.

As you know, I work at the Federal Housing Finance Agency, the safety and soundness regulator for the Federal Home Loan Bank System and Fannie Mae and Freddie Mac. As the Chairman noted, the enactment of the Housing and Economic Recovery Act of 2008, creating this new agency, represented a major step by Congress similar to the task that you now have before you: empowering an agency with a full array of supervisory tools, including explicit authority to impose and enforce prudential standards, including capital standards; obtaining reports from parties on a regular and on an as-requested basis; conducting examinations; requiring remedial actions and authorities to undertake enforcement actions necessary to oversee the housing finance market.

Here are reflected lessons learned about a regulator that lacked a full array of authorities to deal with an increasingly complex financial market. FHFA has deployed a broad supervisory team and has administrative enforcement powers regarding the regulated entities and the ability to access judicial relief if necessary to address third parties through independent litigation authority.

For emergency situations, the agency does not possess a fund such as the Deposit Insurance Fund to cover specified losses. It does maintain a working capital fund and has the ability to make special assessments. Temporary emergency funding was provided in the form of a support agreement with the Treasury Department in 2008.

Including lessons learned from the current financial crisis, I will comment on the structures of S.1217 and what may be improved per the request of the Committee.

S.1217 would establish a new model for a secondary mortgage market and a new supervisory agency, the Federal Mortgage Insurance Corporation, or FMIC. The range of its duties and responsibilities represents a movement away from traditional examination- and enforcement-based supervision to a multifaceted construct that covers availability and transparency of information, standard setting to enter and participate in the market, and supervision of participants. Implementation of these varied elements will require careful planning over the 5-year transition period. It must be noted, however, that a key lesson learned during the financial crisis is that, even with adequate powers, regulators will not always get it right. If taxpayers are going to be exposed to risk of losses, sufficient private capital must be available in front of taxpayers, as contemplated in S.1217.

The bill provides FMIC with limited explicit regulatory authority, though additional tools may be implied and, importantly, an incidental privilege provision is included. Making regulatory authority clear and explicit, including establishing prudential standards, setting capital requirements, and taking enforcement actions, will provide a higher degree of confidence to market participants. These powers are familiar to current participants in the housing finance market and, to the extent they have not been provided to FMIC or are only implied in the bill, they should be made explicit.

As noted, greater sharing of supervisory information among regulators has been a lesson learned; greater cooperation among regulators and greater transparency for markets is essential.

The Committee has posed two key questions: Does the legislation get the right structural pieces in place for the new market to function smoothly? And does it provide for an effective transition from the current system? We have identified some areas where the bill could more fully answer these questions.

The bill authorizes consultation of FMIC with other regulators, but really does not strike an appropriate balance of a two-way street of consultation and cooperation. We recommend that to the Committee.

FMIC and FHFA roles in the Financial Stability Oversight Council should be clarified, and FMIC should have an appropriate and explicit place on the Federal Financial Institutions Examination Council.

There are gaps to be filled, such as oversight of nonbank mortgage servicers, who may not be subject to prudential oversight.

As to funding, the bill provides for FMIC to be funded exclusively by insurance fees. Relying exclusively on such fees as a funding base, particularly as the new market is developing, may present certain challenges. Growing the insurance reserve could require rather large insurance fees in FMIC's early years. These challenges may be addressed by expanding FMIC's sources of funding to include other fees and assessments, such as application fees, which are not explicit, and restoring assessments on the home loan banks for their supervision.

Now, transition to the new agency involves a simultaneous wind down of the enterprises and the transfer of functions and employees from FHFA to FMIC.

FHFA's experience in standing up a new agency argues in favor of immediate transfer of all FHFA personnel and responsibilities to FMIC, thus permitting a smooth integration, a focus on meeting the bill's 5-year goal of full implementation, and maintaining the congressional direction to wind down Fannie Mae and Freddie Mac.

Funding in a transition will also be critical so that there is a smooth start for FMIC with a solid capitalized reserve fund, systems and technology in place, and resources to address challenges that may arise.

I will end. FHFA supports early congressional action to make clear for its regulated entities, for borrowers, and for financial markets the directions you believe most appropriate to protect taxpayers, maintain access to housing finance products and services, and the strongest regulatory structure that is credible, empowered, clearly defined with needed flexibility, and transparent to carry out your directions. While all of this has complexities, that should not deter prudent actions. The certainty that can come from such efforts will benefit homeowners, investors, and taxpayers.

Thank you for your efforts in this direction.

Chairman JOHNSON. Thank you.

Ms. Ellis, you may proceed.

STATEMENT OF DIANE ELLIS, DIRECTOR, DIVISION OF INSURANCE AND RESEARCH, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. ELLIS. Chairman Johnson, Senator Crapo, and Members of the Committee, I appreciate the opportunity to testify before you today regarding the elements of the deposit insurance system that the Federal Deposit Insurance Corporation has found to be the most important in achieving its mission.

Drawing from lessons learned over the deposit insurance system's 80 years of operation, both Congress and the FDIC have made a number of improvements. My remarks will focus on the importance of certain authorities and regulatory tools through the lens of the FDIC's experience. These include clear and explicit statutory authority, ongoing monitoring to assess risk exposure and to take action when necessary, appropriate pricing of insurance, and adequate funding arrangements.

Congress has given the FDIC a clear mandate: to protect depositors and maintain financial stability. Congress has clearly defined by statute the amount of deposits covered under the FDIC's deposit guarantee and the condition—that is, bank failure—that triggers the exercise of that guarantee. At the same time, Congress has allowed the FDIC flexibility to craft specific regulations to cover the many details of its operations.

Clear statutory authority also has been critical to both our supervisory program and our resolution activities. Examination authority and reporting requirements enable us to monitor and control for the risk posed to the Deposit Insurance Fund, or DIF.

For our resolution activities, authorizing statutes delineate the priority of claims and impose general requirements on the way the FDIC resolves failed banks. These statutes enable the FDIC to mitigate losses to the DIF and help maintain financial stability through the timely resolution of failed banks and payment of depositor claims.

An effective insurance program also must include tools to identify and manage risk exposure, not only when insurance is granted but while it stays in force. The FDIC assesses the risk of an institution when it applies for insurance and engages in ongoing monitoring to identify new risks in the banking sector as they emerge. Importantly, explicit statutory authorities allow us to take action when an institution is engaging in potentially unsafe and unsound practices.

Strong capital requirements are one of the most effective means for controlling risk taking by participants in the system, and the FDIC has found explicit capital standards to be an important tool to protect the DIF.

The pricing of insurance also is a key element of a successful insurance system. The FDIC has had experience with both flat-rate and risk-based pricing. Initially, Congress directed the FDIC to charge all banks the same assessment rate. This flat-rate system resulted in less risky banks subsidizing riskier banks and did nothing to reduce the incentives for banks to take excessive risk.

In response to the banking crisis of the late 1980s, Congress ended the flat-rate system and directed the FDIC to adopt a risk-based system. Since 1993, the FDIC has had a pricing system where banks that take on more risk pay more in assessments.

Finally, funding arrangements play a critical role in the success of an insurance system. A well-designed system ensures that adequate funds are readily available to respond to problems as they arise and to avoid delays in closing failed banks or paying insured depositors. Those arrangements also determine the amount and timing of the industry's contributions toward the cost of insurance and the degree of taxpayer exposure.

The FDIC has always had an explicit, ex ante fund paid for by the banking industry to satisfy claims as they arise. Alternative arrangements, such as pay-as-you-go or ex post assessments, increase the risk that bank closings will be delayed, increasing the ultimate cost of failure and undermining confidence in the banking system more generally.

Prefunding for future losses is also more equitable and can be less procyclical. With other arrangements, surviving banks pay the costs generated by those that have already failed, which penalizes those banks that are less risky and imposes costs in the wake of failures when banks can often least afford it.

A more difficult question is that of optimal fund size, which involves balancing significant tradeoffs. The Dodd-Frank Act increased the minimum reserve ratio to 1.35 percent and removed a hard cap, which had required the FDIC to rebate all amounts in excess of 1.5 percent. This new authority gives the FDIC the flexibility to determine the optimal target, so long as it is at least 1.35 percent of estimated insured deposits. This flexibility should allow us to maintain a positive fund balance without having to raise rates sharply when failures spike and banks can least afford to pay for insurance.

Again, thank you for the opportunity to share with the Committee the FDIC's experience and insights. I would be happy to answer any questions.

Chairman JOHNSON. Thank you.

Mr. Regner, you may proceed.

STATEMENT OF KURT REGNER, ASSISTANT DIRECTOR, ARIZONA DEPARTMENT OF INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. REGNER. Thank you for the opportunity to testify today. My name is Kurt Regner. I serve as the assistant director for the Arizona Department of Insurance. Arizona sits on the NAIC's Mortgage Guarantee Insurance Working Group, and it is on behalf of the NAIC that I present testimony today.

State regulators have a responsibility to protect policy holders and ensure competitive markets. As insurance markets evolve, we are engaged with all stakeholders to promote an optimal regulatory framework. We carefully balance solvency standards with the availability of coverage in the mortgage insurance market. We appreciate the desire in Congress to address issues arising from the mortgage transaction, but any legislation must carefully consider the existing regulatory regime.

At its most basic level, mortgage insurance underwrites the risk of borrowers defaulting on their loans. The borrower pays the premiums, and the lender is the beneficiary. Through the most recent financial crisis, the financial sector's collective assumptions about the housing market were proven wrong. This found PMIs exposed on the front lines. After all, they were the ones directly underwriting the risk of borrowers defaulting on their loans. While the main players in the PMI space survived the crisis, they are still recovering.

PMIs are regulated by States in which they do business, with the State of domicile providing primary oversight. State laws and regulations that are specifically tailored for mortgage insurance control the risk PMIs can assume through a variety of limitations, including strict reserve requirements to protect against economic shock, 25:1 risk-to-capital requirements, investment in geographic risk concentration restrictions, and restrictions on nonmortgage insurance-related activities.

The NAIC has a mortgage guarantee model act, and it has been adopted in substantial form by most States primarily responsible for the regulation of PMIs. We have spent the last year considering adjustments to regulatory requirements to address the risks uncovered by the crisis and identified three main problems: overconcentration of originations in a few banks, the cyclical nature of the mortgage insurance product, and the lack of incentives for strict underwriting during boom periods.

I understand you are also interested in financial guarantors. Since Arizona does not serve as a domestic regulator for a financial guarantor, I have limited experience in this area. Nevertheless, I am an experienced insurance regulator. I have some thoughts on the state of the industry.

Bond insurers base their business almost exclusively on selling their credit rating to other parties, initially focused on wrapping AAA ratings around lower rated municipal obligations. In the 1990s, bond insurers expanded their business into structured products. These more complicated investment vehicles, tied to subprime-backed mortgages, exposed bond insurers to greater risk, which became painfully evident during the financial crisis. Since then, the structured bond insurance market has basically dried up. On a positive note, this has created opportunities for surviving insurers and new entrants into the traditional municipal business.

The NAIC has not taken a position on any housing finance reform bills, including Senate bill 1217, but we caution against legislative solutions that solely or substantially rely on the use of PMIs and financial guarantors as the lubricant for the housing market engine.

PMIs appropriately insure individual loans, and there has been little experience with their insuring securities. There may be regulatory concerns with expansion into this business as they could in some cases take on risks in the same loan or type of loan as both a guarantor of the securities and the insurer of the individual loan. Conversely, financial guarantors have substantial experience in the area but failed to live up to their expectations during the crisis. Given our experience, we remain skeptical of their capability of insuring anything other than municipal debt, particularly if the underlying financial instrument they seek to insure itself is not appropriately capitalized and secure. Reliance on these entities should not be considered the panacea which will fix the housing finance market.

Moreover, neither PMI nor financial guaranty insurance should be seen as a substitute for due diligence or sound underwriting by servicers or issuers. The NAIC is concerned with proposals for the creation of a new regulator charged with administering of a Federal guarantee that would have the authority to establish standards for the approval of insurers. Those responsible for a Government guarantee has a strong interest in protecting taxpayer dollars, but appropriate deference should be given to existing State requirements. The incentive is simply too great for a regulator charged with maintaining the viability of a Government guarantee to overshoot the regulatory objective and put in place overly stringent standards that threaten the availability of coverage. Instead, this new regulator should focus on establishing standards for the unregulated entities that may participate in the new housing finance framework and create standards for the administration of the new Government guarantee. As issues of common concern arise, any new regulator should work hand in hand with us to address them, as is done today with other regulatory agencies.

In conclusion, State regulators are committed to working with Congress and other regulators to help ensure competitive, stable housing and mortgage insurance markets. We remain committed to effective regulation of the PMI and financial guaranty industries and to enhancing our regulatory structure where necessary. Good regulation makes for competitive markets and well-protected policy holders.

Thank you again for the opportunity to be here.

Chairman JOHNSON. Thank you.

All Members are now required to report to the Senate floor. I ask the witnesses to stay here until we can determine if we can resume. If not, we will reconvene at a date and time to be determined.

This hearing is in recess.

[Recess.]

Chairman JOHNSON. I call this hearing to order. Thank you all for your patience today.

Mr. Dzivi, I believe you are next in line. You may begin your testimony.

STATEMENT OF BART DZIVI, CHIEF EXECUTIVE OFFICER, THE DZIVI LAW FIRM, P.C.

Mr. DZIVI. Mr. Chairman, Ranking Member Crapo, thank you for continuing this hearing this afternoon, especially on behalf of us panelists from outside of the District. I do want to note for the record, being a former Senate staffer, I had the foresight to book a flight to return tomorrow instead of today.

[Laughter.]

Mr. DZIVI. My testimony is based on my own views and is not intended to reflect the views of any current or former clients of my firm. I commend the Committee for undertaking this hearing and the other hearings related to replacing Fannie and Freddie with a new structure to support housing finance through a vibrant secondary market that relies more on private capital and presents less risk to the American taxpayer. In so doing, the Committee should analyze both what was good about Fannie and Freddie for American homeowners and what was bad about Fannie and Freddie for American taxpayers. I urge the Committee to continue its thoughtful and deliberate approach to this issue.

In framing my remarks today, I will use S.1217 as a point of departure. The introduction of S.1217 by Senator Corker and Senator Warner and their bipartisan cosponsors represents an important first step in raising the issue of creating a permanent replacement for Fannie and Freddie. I do, however, believe there are ways in which the structure proposed in that legislation, especially the regulatory structure, could be improved.

I see two primary regulatory issues:

First, what is the appropriate level of safety and soundness supervision of the various private entities that will be involved in the securitization process of Federal guaranteed mortgage securities?

Second, should the Federal Mortgage Insurance Corporation itself, which will grant Federal guarantees on mortgage securities, be subject to safety and soundness oversight by a separate Federal agency?

When examining the appropriate level of supervision of private entities, given that a Federal credit guarantee is involved, it is critical that any supervision of the private entities participating in the securitization be in the hands of a strong, independent Federal regulator. During the savings and loan crisis of the 1980s, the country learned the hard way that when providing access to Federal guarantees, it may not be prudent to rely on State legislatures and State regulatory officials with weak Federal oversight.

In the 1980s, Congress allowed States wide authority to set the investment rules for State-chartered savings and loans, but allowed these companies to have access to Federal guarantees for deposit insurance. Before Congress slammed that door shut in 1989, weak State supervisors in just a few States loosened the rules and let a group of rogue operators acquire companies and ring up losses on the tab of the American taxpayer in the amount of $124 billion. Congress should be mindful of that history.

I believe this legislation can be improved in three ways:

First, Congress should expand the scope of the private parties who are subject to the Federal agency's authority.

Second, Congress should expressly grant the Federal agency the same powers that bank examiners have to inspect the books and records of entities that participate in the mortgage securitization.

Third, Congress should create an express enforcement system modeled after the Federal banking laws, including the power to issue cease-and-desist orders and prohibition and removal orders for violations of law and also for engaging in unsafe and unsound practices.

If this new secondary market structure is meant to last, then the law must be drawn in a manner to give the Federal agency flexibility with the ability to adapt its rules to changing times and changing financial markets. Otherwise, over time, the agency will be left writing rules applicable to horse-drawn buggies as Google-powered self-driving cars cruise the freeways.

S.1217 grants the FMIC itself the power to issue guarantees of mortgage securities. It does not subject the FMIC to supervision by a separate safety and soundness regulator. I think the sounder approach is to have a separate Federal agency, either a newly created one or the Federal Housing Finance Agency, exercise safety and soundness supervision over all the mortgage securitization participants, both the FMIC itself and the purely private parties doing business with it.

In conclusion, Mr. Chairman, great care must be taken in designing a system where as yet unknown private parties will have access to a Federal guarantee in peddling their wares. Whatever you design will be a huge magnet for those trying to exploit the system to make a quick buck and leave the taxpayers holding the bag.

Thank you, and I look forward to any questions you may have.

Chairman JOHNSON. Thank you.

Mr. Couch, you may proceed.

STATEMENT OF ROBERT M. COUCH, COUNSEL, BRADLEY ARANT BOULT CUMMINGS, LLP, ON BEHALF OF THE BIPARTISAN POLICY CENTER HOUSING COMMISSION

Mr. COUCH. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to be here today to discuss housing finance reform.

Before I get into the substance of my remarks, I want to commend the Committee for the deliberative, bipartisan approach it has taken in examining this complicated but tremendously important subject.

This past March, the Committee heard from my good friend Senator Mel Martinez, who outlined the recommendations of the Bipartisan Policy Center Housing Commission. As Senator Martinez laid out in his testimony, the commission strongly supports the objectives of S.1217, including a multiyear wind down of Fannie Mae and Freddie Mac, a greater role for private capital in assuming mortgage credit risk, and a continued Government presence through a limited catastrophic guarantee of mortgage-backed securities that is funded through the collection of actuarially sound fees. The commission believes that a limited Government guarantee in the secondary market is essential to ensuring widespread access to long-term, fixed-rate, single-family mortgage financing.

The new system envisioned by the commission and outlined in S.1217 will only work with a strong regulator at the system's center. This regulator will function as "Mission Control" for the new system and will be charged with fulfilling two responsibilities that are admittedly in tension: promoting a widely accessible mortgage market, while protecting the wallets of American taxpayers.

Looking at S.1217, let me highlight four areas where I believe the Committee can strengthen the FMIC's role while promoting mortgage liquidity.

First, the commission examined a variety of models around which to design a new housing finance system. We concluded that the Ginnie Mae model offers several distinct advantages, including allowing for a greater number of financial institutions to be issuers of mortgage-backed securities. As applied to the FMIC, it would assure the alignment of interests among all the parties in the mortgage chain and allocate risk among them. As you revisit S.1217, I urge you to consider legislative language allowing the FMIC to replicate the Ginnie Mae model as a part of its ongoing operations.

Second, the commission felt that developing a single security or "common shelf" for single-family mortgages was necessary to ensure the new system's liquidity, interact effectively with the TBA market, and establish an equal playing field for lenders of all sizes. A common shelf also allows mortgages with different terms, interest rates, and other attributes to be pooled into a single security.

Based on our reading, it is unclear whether S.1217 contemplates the FMIC guaranteeing a single, common security or multiple securities. We recommend explicitly directing the FMIC to provide a common shelf for the single-family segment of the market it backstops.

Third, under the commission's proposal, the new regulator would have the authority to temporarily take over the business of issuers, servicers, and private credit enhancers that happen to fail and to transfer that business to other private participants in the mortgage system. S.1217 does not appear to give the FMIC the same type of resolution authority. With resolution authority, the FMIC can help preserve liquidity and ensure a fully functioning market.

Finally, S.1217 provides the FMIC with emergency authority to absorb first-loss credit risk during periods of severe economic stress. But this authority is subject to a number of stringent conditions, including obtaining the written agreement of both the Chairman of the Federal Reserve Board and the Treasury Secretary. The Committee may wish to consider empowering the FMIC with the flexibility to respond more quickly to emergency conditions in the mortgage market.

With respect to the governance of the new regulator, the commission recommended vesting authority in a single individual appointed by the President and subject to Senate confirmation. We concluded that putting a single person in charge of the new system would promote accountability and ease of decision making.

Ginnie Mae does not operate under a board of directors, and in my view, as a former Ginnie Mae president, it has consistently been one of the best-run organizations within the Federal Government. But I certainly understand that the Ginnie Mae governance model is somewhat unique among Federal agencies, and there are logical reasons for establishing a board for the FMIC. The most compelling reason is that rebooting our Nation's housing finance system and running the FMIC is a huge undertaking requiring a deep bench of experience. An engaged, experienced board of directors can be a valuable asset to the FMIC Director.

If, as contemplated by S.1217, the FMIC is to be managed by a board of Directors, then I encourage the Committee to amend the legislation to ensure that members of both political parties are represented on the board. Bipartisan representation on the FMIC board will provide some assurance that the board is making decisions for sound operational and risk management reasons, and not because of political considerations.

Finally, I strongly support S.1217's requirement that members of the FMIC board have significant experience in various specified areas of housing finance. This requirement will help ensure that a full range of experience is represented.

Thank you for your attention, and I look forward to your questions.

Chairman JOHNSON. Thank you.

Mr. Leonard, you may proceed.

STATEMENT OF PAUL LEONARD, SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS, THE HOUSING POLICY COUNCIL OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. LEONARD. Thank you, Mr. Chairman. Mr. Chairman and Ranking Member Crapo, thanks for the opportunity to testify here today.

The Housing Policy Council of the Financial Services Roundtable strongly supports reform of our Nation's housing finance system. Like others have said today, we truly appreciate the time and attention the Committee is devoting to developing bipartisan reform legislation, and we thank Senator Corker, Senator Warner, and their cosponsors for their major contribution to this effort through S.1217.

As others have said, for many years consumers and the housing market benefited from the role that GSEs played in facilitating a secondary mortgage market. However, the financial crisis exposed fundamental flaws in the design and operation of the GSEs. A new model was needed for the secondary market that preserves the availability of stable mortgage credit for qualified homebuyers, retains key operations, systems, and people critical to the current system, but corrects the flaws in the GSE model by requiring more private capital and better protection for the taxpayers.

A critical aspect of a new system is the structure and authority of the Federal agency that will oversee the successors to the GSEs. We support a strong prudential regulator to oversee the private participants and the solvency of a reserve fund that stands in front of any taxpayer backing.

On the structure of a new regulator, the Housing Policy Council supports the structure of the independent agency as proposed in Corker-Warner S.1217, including a governing board, funding through assessments from industry participants, and different divisions to handle key duties such as underwriting and credit risk, as well as advisory committees to allow market stakeholders to provide input to the agency.

On the duties of a new regulatory agency, fundamentally the priority duty of the agency should be to ensure the secondary mortgage market operates in a safe and sound manner. The agency should have the authority to federally charter the key participants in the guarantee securities market and have authorities set standards for that market, including credit terms. To enhance liquidity, the agency should establish the terms and conditions of pooling and servicing agreements and provide for the creation of a single form of guaranteed security. These standards and platforms should apply to the securities that carry the Federal guarantee, not the private label market.

The agency should oversee the establishment of a securitization platform for federally guaranteed securities. The agency must have rulemaking authority, including the discretion to adjust conforming loan limits and set appropriate capital standards, much like Federal banking agencies.

The agency should be required to seek public comment as it exercises its standard-setting authority. Public notice and comment is essential to ensure the understanding of and confidence in the agency's regulatory action.

Where the agency has discretion, it should be required to explain the rationale behind its decisions through regular reports to Congress.

It is important that the agency have examination and enforcement powers, including resolution powers for entities that may fail. The agency should have responsibility for the reserve fund that should stand in front of the Federal guarantee, much like the FDIC's authority over the Deposit Insurance Fund.

Finally, as detailed in my written testimony on our vision for housing finance reform, the Housing Policy Council supports a guarantor structure built around privately capitalized companies chartered and regulated by this new agency. Lenders of all sizes and business models would originate mortgages that meet certain standards and sell those to the guarantors in exchange for mortgage securities or cash. The guarantor would then assume the credit risk on the securities. The securities issued should carry an explicit Federal backstop, and guarantors would pay a fee for that guarantee, part of which would be placed into a reserve fund.

My written testimony also details some important transitional steps we have recommended that FHFA take as a way to move toward this new model such as the securitization platform, additional progress toward a single security, and additional clarity on representations and warranty standards.

We believe the work of this Committee is vital to creating a housing finance system that works for the future, and we encourage you to continue this effort.

Thanks for your time, and I will try to respond to any questions. Thanks, Mr. Chairman.

Chairman JOHNSON. Thank you. Thank you all for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Ms. Ellis, based on your experiences at the FDIC, what tools and authorities does a strong regulator need to protect the fund from losses of bad actors?

Ms. ELLIS. Mr. Chairman, over the FDIC's history, we have found it very important for the FDIC to have the ability to identify, and monitor risk posed to the Deposit Insurance Fund, and to take action where necessary. And we do this in a number of ways. We do this at the outset. We have the ability to deny or approve deposit insurance applications. We have the ability to collect information from members. We have the ability to set minimum capital standards. We have the ability to engage in ongoing monitoring and also, when needed, to take action if risks are escalating.

Some of these authorities are explicit in a statute, and some come from more broad authorities, and we have found both very effective.

Chairman JOHNSON. Mr. Pollard, in your testimony you raise concerns that the implied powers provided to FMIC in S.1217 could undermine the operation of a national housing market. Do you believe that the legislation should be explicit about the supervisory and enforcement authorities that FMIC has?

Mr. POLLARD. Mr. Chairman, the view that we have is that S.1217 is a very strong start. We do believe, as the FDIC commented, that explicit authorities avoid litigation and other problems that can impair action. So that is really where we just believe an elaboration was appropriate.

I would note we believe that the best model is strong and clear legislation, but with the flexibility on implementation to adjust to changing circumstances.

Chairman JOHNSON. Mr. Dzivi, what do you think?

Mr. DZIVI. I concur, and I think the legislation should have express inspection and examination powers and express enforcement powers modeled after the Federal banking laws.

Chairman JOHNSON. Mr. Leonard, what elements of the regulatory structure are needed in legislation in order to provide certainty for market participants? What is flexibility needed? For example, should capital requirements be set in statute or set by the regulator?

Mr. LEONARD. Mr. Chairman, as others have said, I think the regulator should have some flexibility to set capital standards. I think the goal of S.1217, the ability of the system to withstand a significant market downturn is very important, but particularly as in S.1217, if you are allowing different types of credit enhancement, I think the regulator would need the flexibility to set different capital requirements for either an insurer guarantor or a capital markets credit enhancement process. So I think as others have said, I think the regulator needs some flexibility to be able to increase capital and respond to different situations.

Chairman JOHNSON. Mr. Couch, do you agree or have anything to add?

Mr. COUCH. Generally I agree with Mr. Leonard, Mr. Chairman, and we approached it the same way at the commission. We backed into the capital requirements by asking, What would it take in terms of capital to protect the American taxpayer from having to pay on that backstop guarantee, that catastrophic guarantee? And we looked at it by saying what kind of downturn in the market should the system be prepared to withstand, and we said, well, it ought to be something worse than the Great Recession but not as bad as the Great Depression, and we came up with 30- to 35-percent housing price index deflation. And taking that into consideration, we thought that the capital requirement would be some-where in the 4- to 5-percent range. I know S.1217 talks about 10 percent. But the devil is somewhat in the details on that, and that is where the regulator probably needs some discretion to determine what kind of capital we are talking about. Is it leveraged? Is it non-leveraged? You know, exactly how does it work?

So, yes, I would probably agree with Mr. Leonard at a general level but we might disagree on some details.

Chairman JOHNSON. Mr. Regner, the mortgage insurance industry went through difficult times during the crisis. What changes have been made or are under consideration through the regulation of PMI to strengthen this industry?

Mr. REGNER. Chairman Johnson, I am a member of the Mortgage Guarantee Working Group through the NAIC. The working group has been working together for about a little bit over a year now. We are in the process of putting in changes to the Model Act, and included in that Model Act are additional provisions that we feel necessary to protect the mortgage guarantee industry and policyholders.

A number of things that we have included in our model are additional capital surplus standards, revisions to the contingency reserve standards. We have introduced some additional language on the geographical concentration. We have also put some provisions in there in regards to quality assurance. We have put standards in there for underwriting criteria, higher restrictions on dividend releases, higher restrictions on contingency reserve releases. We have put in provisions for rescissions, just to mention a few. But overall we are tackling just about every area that we could think of in order to cover any of the shortfalls that we have felt were needed during the crisis.

Chairman JOHNSON. Mr. Pollard, when Acting Director DeMarco was before the Committee in April, he testified that FHFA was updating master policies and eligibility guidelines for private mortgage insurers. Can you detail the progress on those efforts and how these changes will better protect taxpayers?

Mr. POLLARD. The major point that I can tell you as general counsel is that I have been working with the team working on that. We do expect something to be made public shortly. The whole goal there is to undertake efforts that, first of all, have input that are measured and gradual. And that is what I would tell you today—any phase-in that the Director has ever supported has had those attributes. So right now it is still under review and discussion with the industry.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman, and before I begin asking questions, I want to also thank the members of the panel. You managed to be scheduled just moments before the detonation of the nuclear option on the Senate floor, and we all had to interrupt you and go down for a series of—what was it?—eight or nine votes while we had an unfortunate skirmish.

That being said, you were very polite to remain here with us and continue to be available, and I appreciate that.

Mr. Leonard, I want to start with you, but I would encourage all the witnesses to listen to the question because I would be interested in thoughts that any of you have on this issue. The issue that

I want to discuss with you, Mr. Leonard, is the scope and authorities of the new regulator that we are contemplating establishing in this legislation. Each of you in one way or another, and many others who have commented to us, have talked about how important it is to be sure that certain authorities and powers are given to FMIC if FMIC is established as this legislation contemplates. And as you sit back and look at what we are poised to do here, it is, as I see it, the creation of yet another very big, powerful, comprehensive regulator in our financial system. And I see the need for that.

The question that I have is: How do we assure that we establish this new regulator with the appropriate authorities, powers, and scope but avoid the duplication with the existing regulators in this space and avoid what I consider to be serious potential for increased regulatory cost and burden, inefficiencies, which will then play out in the marketplace as a higher cost of credit and so forth?

So I know it is a broad question, but I think it is a very critical question that we have got to answer. Mr. Leonard.

Mr. LEONARD. Senator Crapo, that is a very good question. I think this is such an important—normally, as a representative of industry, you know, we have—you know, obviously we do not want to be regulated too much. But having said that, this is such an important part of the economy and it is so important to get this right that, you know, significant regulatory authority for this new regulator is necessary.

I think FHFA, through what the Congress did through HERA in 2008, obviously at that time it was too late to save Fannie and Freddie, but FHFA has a lot of the authority now that the new regulator would need. I think it would have to be clarified and added to, since I think the prudential authority to essentially act like a bank regulator, look at their—you know, be able to go in, look at their practice of the guarantors of these new entities that would be providing the private credit enhancement. I think the regulator needs the kind of authority much of which FHFA has now, but I think as others said, it needs to be refined and added to in some respects so that the regulator can understand what is happening in each of these companies, are they following the practices on the types of steps that they should be taking as they do their own due diligence on the mortgages that they are guaranteeing?

I think the point that you make is very true in that there is a lot of mortgage regulation that has already been put into effect through Dodd-Frank, and it is really not now having an effect. You know, I think as we envision it—and others can comment—obviously anything getting the Government guarantee would be a qualified mortgage. I think that a lot—we would ask that the new regulator—and, you know, I think the kind of legal authority has to be carefully considered in terms of is it consultation or coordination or mandated joint rulemaking with either CFPB or some type of coordination on the consumer-facing aspect of mortgage regulation and what originators and the insurers have to do.

So I think we are leery of, you know, too much overlapping regulation, but I think for the most part, for the new entities that would be doing credit enhancement, the new regulator, FHFA Plus or FMIC, would have to have some pretty significant authority.

Senator CRAPO. Mr. Pollard, your thoughts?

Mr. POLLARD. Yes, I think the concern is valid, but I also think we have lessons learned and experience coming from this crisis.

First, many of the participants in this market are already regulated. There needs to be respect for that. I do not think S.1217 disrupts that.

We at FHFA have both formal and informal relationships. As I stressed in my testimony, cooperation and consultation is a very good thing. Many of the rules in Dodd-Frank have required people to work together—sometimes challenging, but I think it has been a good experience in terms of that.

Also, FMIC could employ what now exists similar to the Fed, the FDIC, and the States, which is a State and Federal working group, which can help smooth and make sure things work effectively. I would note that CSBS has been made part of the FFIEC, so the State bank examiners have been incorporated to facilitate that.

I think what Mr. Leonard said is very important. I think markets do want active regulation, appropriate regulation. There is a fear of contagion. We do not want another systemic event. And I believe that making explicit authorities but having some flexibility, as S.1217 proposes, is a course to take. None of us wants overlap or additional burden.

Senator CRAPO. Thank you. And to the other witnesses, my time is up, but if I do not get to come back to you on that, I would welcome your written responses as well.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. It is lonely here today.

Chairman JOHNSON. Yes.

[Laughter.]

Senator CORKER. So we thank you guys for being here, more witnesses than Senators, but I know the record will benefit from your testimony, and thank you all for the patience you have had.

Ms. Ellis, one of the things that people have talked about in the 1217 bill that is generating a lot of discussion—and I know the Committee itself is looking at obviously reforms relative to housing finance—is the issue of hard wiring capital. And some people say, in other words, in the 1217 bill we hard-wire the amount of capital that is necessary in advance of any kind of Government guarantee. And some people have said that is unprecedented, but isn't it true that Section 38 of the FDI Act actually hard-wires capital relative to what your institution is governed by?

Ms. ELLIS. Right, well, Senator, you are referring to what we refer to as the "prompt corrective action rules," and, yes, Congress did define several capital categories, and it also defined restrictions that would occur as you breached different capital categories. And Congress in the law did define the threshold for the worst capital category, if you will, critically undercapitalized. It said that a bank essentially has to have a 2-percent capital ratio in order to stay open.

Above that threshold, for the other capital categories, it left it to the regulators to define what those thresholds would be, but then as I said, it prescribed what the restrictions would be if you breached those. So I would say it is a combination of hard-wired and flexible, and it has served us well.

Senator CORKER. And to Mr. Pollard and to yourself, I guess what we see around here is a watering down of things over time. Could the two of you speak to the benefits of having capital hard-wired in that manner?

Mr. POLLARD. We could consult first, as your bill calls for.

[Laughter.]

Mr. POLLARD. But I think—if I can go first? OK. First of all, we agree with the 10-percent first loss position. It must be real, it must be sustained, and it must create a credible private sector role. The bill does talk about the ability to lower it in a crisis. I think that what I have heard from the private sector a lot, though, is certainty, and what they refer to as the value proposition. They need to know what the rules of the road are.

Putting this in place and, as your bill does, tying it to safer mortgages should not make this a burden. Indeed, it reinforced prudent underwriting. And as I said in my written testimony, and oral, if we are going to put Federal taxpayer dollars on the line, it seems to me that the regulators serve a valuable role, but the private sector needs to be there as well for a sustained participation.

Senator CORKER. Thank you.

Ms. ELLIS. And, yes, as I indicated, we think the capital framework that we have has served us well. Having hard-wired minimums is helpful. It is also helpful to have the flexibility to impose higher capital standards as circumstances warrant, as risks develop in the system or an individual institution.

I would echo the idea that one of the lessons we learned during the crisis is that not only is the amount important, not only should it be sufficient, capital should be of high quality, and it should be there when losses occur. It should not be something that can flee in a time of stress.

Senator CORKER. Thank you. Thank you very much.

Mr. Pollard, one of the things we also sought to do in this bill, especially, again, after we saw what had happened, as Ms. Ellis was referring to, during the crisis and what led up to is, is to also have some underwriting standards, some minimum underwriting standards. They do not address everything, but we have in the bill, one of the bills that is being discussed, 1217, QM plus 5, and I am just wondering if you might respond to something like that being in a bill like this.

Mr. POLLARD. We are very comfortable with that approach.

Senator CORKER. That is not much of a filibuster.

[Laughter.]

Senator CORKER. I am not accustomed to answers like that, but I thank you for that.

Mr. POLLARD. Senator, most of the people that know me are tickled pink that I gave a short answer.

[Laughter.]

Senator CORKER. Mr. Leonard and Mr. Couch, I wonder if—I know you all have looked at 1217. I know that we have had discussions about it in the past. But, generally speaking, do you think that it does a good job of preserving the good things that exist in our housing finance system and eliminating those bad things that exist?

Mr. COUCH. Yes, Senator, I do. Following Alfred Pollard's model for brevity—yes.

Senator CORKER. Very good. Thank you. That is about as clear as it could be.

Mr. Leonard.

Mr. LEONARD. Senator, we agree. I think S.1217 goes a long way toward correcting those problems, and obviously capital is one, regulation is another, and, you know, we are talking about not FHFA but OFHEO, the types of authorities that OFHEO had at the time. And issues like portfolio—you know, there should not be—and I think it has been well discussed in the Committee, and you have made the point. You know, you should not have a portfolio for arbitrage purposes. The portfolio should be for developing or maintaining a market, and it is obviously different from the single-family to the multifamily, but we agree there.

So I think the short answer, not to filibuster, is that we think the bill has most of the things needed for reform.

Senator CORKER. Thank you all for your testimony, and, Mr. Chairman, for having the hearing.

Mr. COUCH. Senator, can I amend my statement with just one short sentence? With respect to your question about capital, the Bipartisan Policy Center is going to host on December 11th a daylong session that will bring in private marketplace participants, as well as Senators Johnson and Crapo, to address that very issue. So we hope you will send some representatives to hear what our folks have to say. Thank you.

Senator CORKER. I am sure they will be there. Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and I appreciate all of your testimony. I was at a hearing on a disability treaty, so I had a chance to glance through some of the written testimony, and I appreciate it on this subject matter. But I want to direct my questions to Mr. Pollard since I do not always have the opportunity to have you before the Committee. With reference to Director DeMarco's intentions to unilaterally reduce the maximum size of mortgage loans that Fannie and Freddie can finance, families in my home States of New Jersey, like many other families in States throughout the country, can face particularly high housing costs, and I am concerned that the reductions to the conforming loan limits can disproportionately harm them.

So we, meaning a group of bipartisan Senators, including Senator Isakson as well as several Members of this Committee, sent a letter to Mr. DeMarco basically urging him not to take unilateral actions and questioning whether or not he had the authority to do so.

Now, I would like to know from you as the agency's counsel, is the agency taking the position that Congress has expressly delegated authority to it to reduce the maximum size of loans financed by Fannie and Freddie or is it interpreting the scope of its conservatorship powers to include that authority?

Mr. POLLARD. Senator, let me address both legal and policy, if I might——

Senator MENENDEZ. Well, if you can just address the legal——

Mr. POLLARD. I will address the legal then. The statute for well over 50 years has provided that the GSEs set limits; that is the first part; second, that the limit may not exceed a maximum, which is set through a formula. Thus, the maximum is not a mandate nor a floor. The Director in—so the enterprises at any time could have set a lower limit. They did not have to go to what is called the maximum.

In the conservatorship, where the Director stands in the shoes of the board and management, he then has the same authorities and may set that limit.

Senator MENENDEZ. So your response to me is then saying you have both the legal authority and to the conservatorship powers you can do it either way. Is that what you are saying to the Committee?

Mr. POLLARD. Yes.

Senator MENENDEZ. Well, in 2011, the Director told the House Financial Services Committee, and I quote, "I do not intend to act unilaterally in lowering the loan limits because the Congress of the United States has been so active in repeatedly involved in adjusting the conforming loan limits that I really and truly believe that the Congress of the United States is the body that should make the determinations about the future path of the loan limit if it is going to be something other than what current law provides."

Mr. POLLARD. Right. That quote was in part of a response to a broader question on loan limits in general. But what I would note is he indicated talking about Congress and the maximum loan limit. The ability within that loan limit has never been altered by Congress, including when they adjusted the loan limit. They have not——

Senator MENENDEZ. So you are suggesting that if Congress does not want the Director to arbitrarily and capriciously on his own, despite a feel that Congress has repeatedly been engaged in setting, that, in fact, we should change the law to limit what he, in fact, can do in decreasing loan limits?

Mr. POLLARD. All I can say is that the construct that I have to analyze every day provides for the GSEs to set the limits, and there is a maximum that has been set and calculated, and that was set by Congress.

Senator MENENDEZ. Well, it seems to me that if Congress has actively and repeatedly been involved in adjusting the conforming loan limits, it would suggest that Congress has not delegated to the FHFA the discretionary authority to adjust the loan limits without an express authorize. It just also seems to me, with Congress actively considering housing finance legislation, as demonstrated by this hearing, and many other Members of this Committee who have had this view held on this topic, why does the FHFA think that now is a good time to take unilateral action on an issue in which it acknowledges Congress has shown a clear and repeated interest? I find the timing puzzling, to say the least. And for some of us, it will invoke a reaction that will be far more limiting to your agency's abilities.

Mr. POLLARD. What I would say is that the Director has indicated that he is very attentive to the market here and very sensitive to that. He has provided notice about this. He has indicated any change would be gradual. It would have a longer phase-in. And it is still under review, Senator.

Senator MENENDEZ. Well, finally, if I may, Mr. Chairman—and I am glad that you reconvened so that I could actually get here—I hope if the agency has an analysis as it relates to the benefit here—because it seems to me that everything I have seen is that loans that would be excluded by a reduction in the loan limits actually performed better than the average. And it seems to me that even if—or even if they have a positive value, that without ordering the GSEs to stop financing them would be an action that worsens rather than improves the GSEs' financial position. I would like to see all of this analysis that drives this decision, even in the face of repeated congressional action in a bipartisan basis. It just boggles my mind.

Thank you, Mr. Chairman.

Chairman JOHNSON. We will go with another round.

Ms. Ellis, the structure of the FDIC Board tries to ensure diversity and independence while also balancing the background of the Board members with their duties to protect depositors. In your opinion, what are the strengths of this model? Could this model work for a new secondary mortgage market regulator? Also, do the FDIC's advisory committees, like the Community Bank Advisory Committee, provide a good avenue to consider stakeholders' views?

Ms. ELLIS. Mr. Chairman, in my experience in working with various members of the FDIC Board of Directors, they take their jobs very seriously. In fact, prior to assuming my current position, I worked as deputy to one of our current Board members, so I saw this up close. As you indicated, there are certain requirements ensuring some aspects of diversity on our Board of Directors, and it has been my view that having people with a broad range of experience and good judgment is important. Also important is to avoid conflicts of interest. There are certain rules in place that, for example, prevent the Board of Directors from working for an insured depository institution at the same time, and there are certain post-employment restrictions if they do not serve a full term. Things of that nature are very helpful.

As far as the advisory committees go, yes, we have actually several advisory committees right now. You mentioned one, Community Bank Advisory Committee. We also have one on financial inclusion and another on systemic risk. And it is a very good way to get industry and other public views' input on important policymaking decisions.

Chairman JOHNSON. Mr. Leonard, S.1217 proposes the regulator have, within the consent of other officials, emergency powers in a crisis that lasts only 6 months. Should we consider expanding that authority of providing other countercyclical tool that a regulator may need in a future crisis?

Mr. LEONARD. Thank you, Mr. Chairman. We have not taken a formal position on that, but I think it is worth considering that the regulator may need more—you know, as we saw from this last crisis, you know, at different times there were different estimates on whether we were recovering or whether it was continuing. So I think our initial view is that the regulator may need more flexibility than just 6 months.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and before going back to my first question with the witnesses who did not get a shot at it, I do want to try that, but I wanted to follow up quickly, Mr. Pollard, with you on the question of loan limits.

As I understand it, your explanation is that there is a loan limit, and then there is an authorized maximum amount of loan that will be authorized as the entities are managed. And I get that. There is, as Senator Menendez indicated, a continuous debate here in Congress about what we should set as the loan limits.

But I wanted to give you an opportunity to get into the policy considerations about why we should or should not be setting the maximum authorized loans at this point at the highest levels possible or at the current levels that are being discussed.

Mr. POLLARD. Right. I do not think the issue is whether Congress has set them. I think the issue for me, and trying to be the person who avoids the Director doing anything arbitrary and capricious, is that the maximum—the language in the statute begins with, "The enterprises shall set limits." It says this about three times, and then only says that the maximum limit "should not exceed . . . ."

Senator CRAPO. Right.

Mr. POLLARD. So the policy behind this right now is—and I should have had a chance to say to Senator Menendez, and I apologize for this—that we also have a policy to try and reduce the footprint of the enterprises in the marketplace which stands at 75 percent of the entire domestic mortgage finance market. And this is part of an effort of several steps. We are trying to do new credit risk transfers that are recognized in S.1217 to share risk. We are talking about a 10-percent insurance type approach with a first loss. All of this is to bring in more private sector and restore more of an equilibrium and reduce the burden on taxpayers. So I think that is part of the coordinated effort.

We certainly have heard the debate on this. The Director is very sensitive—he said there would be tons of notice—very sensitive to how the market would adapt to any change. And, again, it is under review and, you know, it has not occurred yet.

Senator CRAPO. Thank you. And before I get back to my first question, I want to quickly ask you, Mr. Regner, in your role as the assistant director for the Arizona Department of Insurance, I am sure you have dealt with the myriad of issues affecting mortgage insurance from undercapitalized private mortgage insurance companies to regulatory interaction among various entities at both the State and Federal levels.

What specific powers should the new Federal regulator have to effectively deal with the private market insurers in a reformed housing finance system?

Mr. REGNER. Well, before, I guess, to answer the question, I think from our testimony that I gave today we feel that the powers or the guidance that is directed within the bill, that the solvency and capital standards should still be maintained and regulated by the States in order to maintain a capital level that is adequate to allow for new entrants and for the continuation of a competitive market. Capital is very expensive. When you get into areas of getting into it being excessive, the possibility of loss of entrants or the continuation of that line of business could be lost. That is some consideration you may want to think about. And, of course, the NAIC staff would be more than happy to work with you in regards to maybe coming to some sort of resolution to that type of concern that we have.

Senator CRAPO. All right. Thank you.

Now I will just get back to the four of you who did not get a chance, if you choose, if you would like to, to respond to my first question, which was really the broader question of how do we solve this issue of creating a very, very, what I see as extensive and powerful new regulator in a field where we already have very significant regulators playing in a number of different positions. And how do we make sure that we give appropriate authorities to but assure that we do not simply pile on, if you will, the regulatory level of burden that we have put on our housing finance system? Would any of you like to jump into that?

Ms. ELLIS. Sure. I would be happy to.

Senator CRAPO. Ms. Ellis.

Ms. ELLIS. I would be happy to share some of our experiences at the FDIC. Hopefully it will be helpful. The FDIC has a long history of working with other regulators, both at the State and Federal level. We are primary supervisor for some banks in the U.S., but we are a backup supervisor for other banks in the United States. And where we are backup supervisor, we have well-established protocols, some facilitated by statute, others facilitated just by informal agreement among the agencies, for things like information sharing, the sharing of examination reports, participation on examinations, and even when it comes to disagreeing over the condition of institution, we actually have protocols for how to go about disagreeing. All of these are important to reduce the duplication that goes on as well as the confusion that it could cause to the regulated entity.

Senator CRAPO. Mr. Dzivi.

Mr. DZIVI. Yes, Senator. I think one of the key methods of increasing the efficiency of the regulatory structure is the sharing of information, and there are provisions in the draft legislation that permit sharing of information, but Congress may consider actually requiring sharing of information because sometimes agencies like to butt heads a little before they turn over each other's documents. So that might be one thing for Congress to consider.

Senator CRAPO. Thank you.

Mr. Couch.

Mr. COUCH. Senator, I cannot add to—the other witnesses have adequately described the cooperative systems that are in place now, but I would compliment you for thinking about it because it is important, and I think it should be covered.

Senator CRAPO. Thank you. Mr. Regner.

Mr. REGNER. Just a quick comment. Information sharing is very important to keep that avenue open so that we can learn off each other's experiences and the work that we both have put into the efforts of looking at these type of industries.

Senator CRAPO. Mr. Leonard.

Mr. LEONARD. Senator, just one more point on your question. For example, in the area of mortgage servicing, I think there is more that could be done to improve coordination particularly in loss mitigation requirements. And obviously there was a need for improved loss mitigation because servicers did not have adequate standards, as we found out during the crisis. But now you have multiple standards. You have Making Homes Affordable, you have the National Mortgage Settlement, you have the OCC consent agreements, and you have CFPB and GSE guidelines. In some areas, many of these are coordinated. In others, the requirements are slightly different, so servicers are operating, you know, in times—like, for example, times where you have the number of days you have to respond to the customer, things like that.

I think as you look at a bill, like, for example, on servicing standards, additional thought about how the agencies can coordinate, and it is moving together but there is still—what we hear from servicers, there are a number of different—standards still vary, and it causes some confusion. So I think it is an area that still needs to be looked at.

Senator CRAPO. Thank you. Mr. Pollard, you get the last word.

Mr. POLLARD. Thank you.

Senator CRAPO. Unless the Chairman wants to give somebody the last word.

Mr. POLLARD. I want to be sure that something is made clear that a lot of us have used terms today, and I want to be sure I am clear for the Committee on our perspective. We talked a lot about setting standards in the market. I think it is very important to recognize that third-party service providers are very important, and any regulator that is providing a successful standard like this has to be able to look at them. They do pose potential risk. So people one step away from the person you are dealing with may be very important, and I think that is one of the things we are talking about. I do not want to mislead the Committee. We think that ability, that capacity, is needed.

And, second, when you are putting Federal taxpayer dollars on the line, I think there is a challenge to address the reach of the Federal authorities here. They need to be broad. We are talking about putting Federal tax dollars on the line and the ability of the Federal Government to be able to look into, to track, to set standards that may affect all regulated parties. Within this framework, not expanding it, but within the very area we are talking about, just this area, is part of an interesting point that I do think needs to be addressed and confronted.

Senator CRAPO. Thank you. I am sorry I went a little over there, Mr. Chairman.

Chairman JOHNSON. Thank you to all of our witnesses for being here today. I want to thank Senator Crapo and all of my colleagues for the time today to discuss the structure of the new secondary market regulator.

This hearing is adjourned.

[Whereupon, at 3:26 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF ALFRED M. POLLARD

GENERAL COUNSEL, FEDERAL HOUSING FINANCE AGENCY

NOVEMBER 21, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for your invitation to testify on the powers and structure of a regulator for a revised housing finance system. My name is Alfred M. Pollard and I am General Counsel for the Federal Housing Finance Agency (FHFA), which is the safety and soundness regulator of the Federal Home Loan Bank System and Fannie Mae and Freddie Mac. The introduction of S.1217 and the work of the cosponsors and of the Chairman and Ranking Member in moving forward with housing finance reform are important steps. I have addressed the questions you put to me in your letter and will be pleased to answer any questions you may have.

Supervisory Tools Available to FHFA

Following enactment of the Housing and Economic Recovery Act of 2008 (HERA), the new Federal Housing Finance Agency came into existence with an enhanced array of supervisory tools. These include explicit authority to impose and enforce prudential standards, including capital standards; obtain reports from parties on a regular and on an as-requested basis; conduct targeted and full scope examinations; oversee executive compensation, including incentive compensation and golden parachutes; require remedial actions; and authorities to undertake a full range of enforcement actions.

FHFA's predecessor as supervisor of Fannie Mae and Freddie Mac was the Office of Federal Housing Enterprise Oversight (OFHEO). In general, OFHEO did not have a full range of authorities, including authority to set capital requirements or to undertake supervisory actions that were comparable to those of other financial regulators; HERA corrected that. At OFHEO, congressional appropriations were required, subjecting the regulator to potential disruptions if a budget were not in place; HERA corrected that. At OFHEO, no receivership authority existed which symbolized a regulator without a full range of capacities; HERA corrected that. At OFHEO much had to be done with implied authorities; HERA corrected that, providing explicit authorities and language regarding "incidental authority." In addition, by merging OFHEO and the Federal Housing Finance Board, FHFA's predecessor as supervisor of the Federal Home Loan Bank System, HERA increased synergies over the regulation of the Government-sponsored sector of the housing finance market. Overall, HERA made important changes to the regulatory authority over Fannie Mae and Freddie Mac, but by the time the law was passed it was too late to implement those authorities prior to the need for conservatorships.

More specifically, let me cover a few of the basic regulatory tools that FHFA has today:

Supervision and Examination. FHFA has a full array of supervisory tools, many of which were unavailable to OFHEO, but provided under HERA to FHFA. Since its creation in 2008, FHFA has implemented these tools through a comprehensive supervisory program described here.

FHFA supervision is carried out by two divisions—the Division of Enterprise Regulation with responsibility for Fannie Mae and Freddie Mac and the Division of Bank Regulation with responsibility for the 12 Federal Home Loan Banks and the Office of Finance. Both Divisions employ on-site examination and off-site analysis and carry forward prudential standards set forth in regulation to meet FHFA's responsibilities relating to safety and soundness and compliance with laws and regulations.

With respect to Fannie Mae and Freddie Mac, even in conservatorships, FHFA maintains a permanent on-site presence of examiners who conduct examinations and monitor business activities, key risks and compliance. With respect to the Federal Home Loan Banks, FHFA typically carries out three on-site examinations per quarter so that all 12 FHLBanks are examined on-site once per year. As with Fannie Mae and Freddie Mac, FHFA has an ongoing program of off-site monitoring of the FHLBanks.

FHFA has established comprehensive examination manuals that serve as guides for examination efforts and are available to the regulated entities and to the general public. FHFA continues to issue Advisory Bulletins on a timely basis regarding key matters such as credit risk management and model risk governance. Typically, these are based on best practices that have emerged in bank regulation, though appropriately adapted to the unique characteristics of our regulated entities, starting with the fact that they are not commercial banks. FHFA remains the only financial regulator tasked with providing an annual report to Congress on its examination results.

FHFA's two supervisory Divisions work closely with the Division of Housing Mission and Goals that has expertise in mortgage-related products and markets, to ensure the agency maintains a comprehensive view of risks and housing finance activities. Together these three divisions also conduct the mission oversight of the regulated entities.

With Fannie Mae and Freddie Mac each in conservatorship, FHFA's oversight of these companies goes beyond traditional supervisory activities. As the conservatorships have lasted far longer than originally anticipated, FHFA has responded by developing an Office of Conservatorship Operations and an Office of Strategic Initiatives that carry out FHFA's responsibilities regarding the current operations of the conservatorships. These Offices coordinate and collaborate with the other divisions to enable FHFA to meet its responsibilities and its mission of ensuring our regulated entities operate in a safe and sound manner so they may serve as a reliable source of liquidity and funding for housing finance and community investment.

Enforcement. FHFA may take a broad range of enforcement actions by statute and, by regulation and policy guidance, has elaborated on the conduct of such powers. Cease and desist orders, civil money penalties, debarment of officials, the ability to act against institution-affiliated parties all exist within the ambit of our statute; additionally, the Agency has created a process for suspending individual or corporate counterparties found guilty of criminal law violations. Overall, FHFA has broad administrative enforcement powers regarding the regulated entities and the ability to access judicial remedies if necessary to address third parties through its independent litigation authority.

Emergency Tools. HERA provided FHFA a broad range of regulatory tools for addressing emergency situations. The Agency does not possess a fund such as the Deposit Insurance Fund to cover specified losses, but it does maintain a working capital fund and has the ability to impose special assessments on the regulated entities to address any shortfalls in its resources in order to respond to emergency situations. Temporary emergency funding was provided in the form of a support agreement with the U.S. Treasury Department in 2008 and this remains the main source of funding to provide capital support to the conservatorships. Finally, FHFA has employed its authorities and they have been affirmed in a number of important court rulings.

As to those court decisions, several have aided in rounding out FHFA authorities. Significantly in a case in the Southern District of New York, the Court found not only that FHFA had examination privilege, but also shared similar authorities to banking regulators. This solidified the examination privilege that facilitates effective supervision, but as well made clear that FHFA supervisory actions find support in long-standing bank regulatory powers. For a new agency, these judicial decisions are important.

In sum, the agency is equipped to meet the mission Congress has set for it. What I will now address is the regulatory structure set forth in S.1217, and, based on some of the lessons learned during this crisis, where areas exist for improvement in terms of regulatory structure and powers.

S.1217, Housing Finance Reform and Taxpayer Protection Act of 2013

FHFA has endorsed the need for legislative action on housing finance reform. S.1217 is an important effort in moving that process forward.

Proposed Regulatory Structure. S.1217 would establish a new model for the secondary mortgage market and a new supervisory agency, the Federal Mortgage Insurance Corporation (FMIC). The range of FMIC's duties and responsibilities represents a movement away from traditional examination- and enforcement-based supervision to a multifaceted construct that covers availability and transparency of information, standard-setting to enter and participate in the market, supervision of participants, access to credit and the secondary mortgage market, insurance of securities and establishment and operation of databases including a mortgage data repository. Implementation of the bill's varied elements will require careful thought and planning over the 5-year transitional period and the undertaking of appropriate transitional steps. It must be noted, however, that beyond the regulatory structure and authorities, a key lesson learned during the financial crisis is that, even with adequate powers, regulators will not always get it right; therefore, if taxpayers are going to be exposed to risk of losses, sufficient private capital must be available in front of taxpayers, as contemplated in S.1217.

Regulatory Tools That Should Be Added. The bill provides FMIC with limited explicit regulatory authority, though additional tools may be implied and, importantly, an "incidental powers" provision is set forth. Making regulatory authority clear and explicit, including where appropriate the ability to establish prudential standards, set capital requirements and take enforcement actions, would enhance market stability and provide a higher degree of confidence to all market participants. Further, the ability to address both the primary parties to be regulated and to have certain authorities in relation to their contractual counterparties would be in line with existing legal practice. Where the bill implies authority, but does not expressly confer it, action FMIC would determine to take could lead to litigation and result in different outcomes in different jurisdictions, undermining the operation of a national housing finance market.

Reliance on implied authority also makes it difficult to say what is missing. What is clear is that FMIC needs a full array of supervisory and enforcement authorities with regard to the market participants for which it must set standards and approve entry, including the authority to set capital standards, request reports from and examine these participants, establish enforceable prudential standards, require participants to undertake remedial actions where appropriate and impose penalties for bad behavior and bad actors. In the structure proposed in S.1217, providing FMIC with these tools is not only important for market integrity, but also to protect taxpayers in light of the risks associated with FMIC insurance. These powers are familiar to current participants in the housing finance market—many of which are already subject to supervision by FHFA or by a State or Federal regulatory authority—and to the extent they have not been provided to FMIC or are only implied in S.1217, they should be made explicit.

FHFA has provided language to demonstrate how these powers, which could be implied and are incidental to other authorities already expressed in S.1217, could be made clearer in the bill. For example, FMIC has authority to approve or suspend approval for participants and "suspending" implies requiring remedial action; this should be made explicit. Also, FMIC's authority to revoke approvals implies the ability to revoke participation and thus prohibit participation; such prohibition should be made explicit.

Finally, as reaffirmed by the crisis, greater sharing of supervisory information among regulators, greater cooperation among regulators, such as FHFA–CFPB efforts on a national mortgage data base, and greater transparency for markets, such as FHFA directing the publication by the Enterprises of historical loan data, are critical. These are core areas on which FHFA is working and will continue to build.

Improvements to S.1217 Regulatory Structure. Because S.1217 sets a new direction for the housing finance market, two questions are critical—as the Committee has asked, does the legislation get the right structural pieces in place for the new market to function smoothly and efficiently and does it provide for an effective transition from the current system to the new market? FHFA has identified some areas where the bill could more fully answer these questions.

For example, S.1217 acknowledges that many likely participants in the new market are already subject to prudential supervision by other safety and soundness State or Federal regulators by authorizing consultation or directing FMIC to coordinate with another agency, but more could be done to ensure that other regulators share information with FMIC and that exams are coordinated, reducing burdens on participants and improving supervisory approaches and outcomes. FMIC and FHFA roles in the Financial Stability Oversight Council should be clarified to ensure that during market transition appropriate representation remains in place. FMIC should have an appropriate and explicit role in the Federal Financial Institutions Examination Council.

There may also be gaps to be filled. For instance, today all mortgage servicers are subject to certain compliance oversight with regard to consumer protections, but nonbank servicers may not be subject to prudential oversight. The bill does not address enhanced supervision of nonbank servicers, even though their safety and soundness and their conformance with required practices are critical to FMIC's mandate to protect taxpayers. Assigning regulatory oversight to FMIC with the ability to set and enforce prudential requirements could help fill this gap. Additionally, FHFA has seen certain State and local laws that may impair the efficient operation of a national secondary mortgage market.

The bill also provides for FMIC to be funded exclusively by insurance fees, which would be collected on mortgage-backed securities that FMIC insures. Relying exclusively on fees as a funding base, particularly as the new market is developing, may present certain challenges. Clearly, at its inception, FMIC should have sufficient resources to be fully operational and sound. Further, funding FMIC and growing the insurance reserve could require rather large insurance fees in FMIC's early years. In times of market distress, FMIC revenues could drop substantially. These challenges may be addressed by expanding FMIC's sources of funding to include other fees and assessments; for example, creating application fees, which are not explicit, and restoring assessments on the Home Loan Banks for their supervision.

Transition. Transition to the new agency involves a simultaneous wind down of the Enterprises and the transfer of functions and employees from FHFA to FMIC and the hiring of additional employees as needed to fulfill the new agency's responsibilities. FHFA was created 5 years ago by merging the functions and employees of three agencies—OFHEO, the Finance Board and elements of the Department of Housing and Urban Development—into a single agency with all of the functions of its three parts. Here, the transition involves employees from one agency, but into a framework with multiple responsibilities. S.1217 establishes a two-step transition that would have FHFA and FMIC coexist for 5 years, which could be confusing and inefficient for both market participants and agency employees.

FHFA's experience in standing up a new agency would argue in favor of immediately transferring all FHFA personnel and responsibilities to FMIC, thus permitting a smooth integration, a focus on meeting the bill's 5-year goal of full implementation and maintaining the congressional direction to wind down Fannie Mae and Freddie Mac. In particular, moving all employees to the new agency—or, possibly, renaming and empowering FHFA as FMIC—avoids issues of dispersion of resources and expertise that may prove beneficial to the various tasks assigned in the legislation. Guidance would be helpful on the legal authority of FMIC's Director to act before the Board is fully constituted. Funding in transition may be critical to assure that a smooth start for FMIC occurs with a solid capitalized reserve fund, systems and technology in place and providing resources to address challenges not anticipated at this time.

New Utilities. FHFA continues work on the Common Securitization Platform. As FHFA and, later, FMIC move to develop more fully the National Mortgage Database and an approach for a national mortgage market repository for notes and other documents, it may be beneficial to address these two items with additional legislative language. A national note repository can bring benefits to homeowners, lenders, the State foreclosure process and efforts of groups such as the Uniform Law Commission to make more uniform State foreclosure laws.

Conclusion

FHFA continues to support early congressional action to make clear for FHFA, for its regulated entities, for borrowers and for financial markets the directions you believe most appropriate to protect taxpayers, maintain access to housing finance products and services and the strongest regulatory structure that is credible, empowered, clearly defined and transparent to carry forward your directions. While all of this has complexities, that should not deter prudent actions.

In closing, FHFA appreciates the opportunity to work with you and your staffs and those of the cosponsors, as well as those of other Committee Members, to assist in any way we can as you move forward on this critical task of addressing a new housing finance structure. The certainty that can come from such efforts will benefit homeowners, investors, and taxpayers.

PREPARED STATEMENT OF DIANE ELLIS

DIRECTOR, DIVISION OF INSURANCE AND RESEARCH, FEDERAL DEPOSIT INSURANCE CORPORATION

NOVEMBER 21, 2013

Chairman Johnson, Senator Crapo, and Members of the Committee, I appreciate the opportunity to testify before you today on "Powers and Structure of a Strong Regulator". As the Committee considers reforms to the Nation's housing finance system, including insurance and supervisory models similar to the Federal Deposit Insurance Corporation (FDIC), you have requested that we provide you with a description of the elements of the deposit insurance system that are the most important in achieving our mission.

Many lessons have been learned over the deposit insurance system's 80 years of operation. Drawing from these lessons, both Congress and the FDIC have made a number of improvements to the deposit insurance system. During our history, which includes two serious banking crises in the last few decades, certain authorities and regulatory tools stand out as particularly important. These include clear and explicit statutory authority, monitoring to assess risk exposure and to take action in response when necessary, appropriate pricing of insurance, and adequate funding arrangements. In addition, the FDIC has experienced the challenges of managing a transition between agencies, which occurred when the Resolution Trust Corporation, created to resolve failed savings and loan institutions during the early 1990s, was folded into the FDIC at the conclusion of that crisis.

My testimony today elaborates on and describes these important authorities and tools through the lens of the FDIC's experience. In some cases, the elements of our regulatory and insurance regime may be relevant primarily to the FDIC's unique role and mission. In other cases, the Committee may determine that the lessons we have learned over the years provide insights that may be useful to the Committee in this important work. The FDIC stands ready to provide assistance to the Committee in this effort.

Explicit Authority

Since its founding in 1933, Congress has given the FDIC a clear mandate: to protect depositors and maintain financial stability. The FDIC has been successful in its mission in large part because Congress has clearly defined by statute the amount of deposits covered under the FDIC's deposit guarantee and the condition—bank failure—that triggers the exercise of that guarantee. At the same time, Congress has allowed the FDIC flexibility to craft specific regulations to cover the myriad details of its operations. The clarity of Congress' mandate provides credibility in the eyes of depositors, virtually eliminating the risk of bank runs and panics, thus providing a foundation of stability to our banking system during times of financial distress. While the banking industry pays the costs of deposit insurance, the full faith and credit of the U.S. Government ultimately backs the FDIC's deposit guarantee.

The existence of clear statutory authority over the years also has served as the foundation of our supervisory approaches. Statutes clearly state congressional expectations and goals, enabling us to monitor and control for the risk posed to the Deposit Insurance Fund (DIF). For example, certain laws, such as prompt corrective action, provide statutory tripwires for supervisory action. At the same time, the statutes outlining our supervisory authorities provide flexibility to create a robust examination process within the statutory grant of authority.

Clear statutory authority also has been critical to the FDIC's resolution activities, which enable us to mitigate losses to the DIF and help maintain financial stability through timely resolution of failed banks and payment of depositor claims. Our authorizing statutes delineate the priorities of claims and provide direction to all parties in the claims process. This clarity enables the FDIC to resolve failed financial institutions efficiently and effectively, usually over the span of a single weekend.

Monitoring and Controlling Risk

An effective insurance program must include a variety of tools to identify and manage risk exposure, not only at the time when insurance is granted but also while that insurance stays in force. As deposit insurer, the FDIC assesses the risk of an institution at the time that it applies for insurance. After admittance into the system, the FDIC monitors the condition of that institution through on-site examinations and remote monitoring, and through our back-up examination authority in the case of an institution primarily regulated by another Federal banking agency. Risk mitigation should include setting explicit capital standards and must be an ongoing process that allows for intervention before losses occur and insurance must be paid out. While the FDIC is not the primary Federal regulator of all FDIC-insured institutions, all FDIC-insured institutions are subject to the same, or very similar, framework of regulations, policies, guidance, examination protocols, ratings, capital standards, reporting requirements, and enforcement authority.

In determining membership participation in the deposit insurance system, the FDIC carefully considers factors prescribed in section 6 of the Federal Deposit Insurance Act (FDI Act) and implements policies and guidance that supplement the factors when conducting reviews of deposit insurance applications. These factors include the financial history and condition of the institution, adequacy of the capital structure, future earnings prospects, general character and fitness of management, risk presented to the DIF, convenience and needs of the community to be served, and the consistency of the institution's corporate powers with the purposes of the FDI Act. Under one housing finance model the Committee is considering, the Government insurance fund would have authority to approve participation by four types of companies: private mortgage insurers, servicers, issuers, and bond guarantors. The factors for approving each of these companies differs slightly, and are similar to, but not the same as, the statutory factors found in section 6 of the FDI Act which the FDIC uses to determine eligibility for Federal deposit insurance.

Capital Requirements

Strong capital requirements are one of the most effective means for controlling risk-taking by participants in the system and the FDIC has found explicit capital standards to be an important tool to protect the DIF. As mentioned above, the prompt corrective action framework in section 38 of the FDI Act defines minimum capital ratios and imposes progressively tighter restrictions on an institution's activities once these minimums are breached. The ratios defined in section 38 are intended to trigger regulatory sanctions when banks become less than well capitalized, but individual institutions may be required to hold capital levels that are higher than statutory minimums based on their risk profile and activities. As the Committee considers various legislative approaches, it may want to consider inclusion of explicit capital standards for all significant participants in the new system and the consequences of breaching those standards.

Ongoing Monitoring and Reporting Requirements

Requirements for ongoing monitoring, reporting requirements, and access to records are essential to an effective regulatory regime. In the FDIC's case, these tools enable banking regulators to supervise FDIC-insured institutions on an ongoing basis and to identify and respond to increasing risk in the system. Providing the proposed mortgage insurer with similar authorities would enable that insurer to determine independently a participant's financial condition and compliance with laws and standards. For example, the FDI Act provides for the authority to conduct examinations and investigations, the minimum frequency of examinations, the authority to examine affiliates and other related entities, coordination and information sharing with other agencies, and penalties for obstruction of examination authority, among other things.

This statutory examination authority underpins our program of regular examinations and is supplemented by regulations, policies (including the standard CAMELS ratings system used for all FDIC-insured institutions), guidance, and procedural manuals. Importantly, this authority also allows the FDIC to review examination findings for banks we do not supervise directly and to conduct backup examinations and reviews of those institutions as necessary. Similarly, a statutory basis for regular examinations and investigative authority would enhance the mortgage insurer's on-site monitoring ability. Where participants are subject to oversight by other Federal or State agencies, the proposed law could clarify requirements for coordination of examination activities and information sharing agreements.

Additionally, supervisory monitoring efforts are enhanced through review of quarterly Call Reports that are required by section 7 of the FDI Act, provisions of which also impose penalties for failure to file accurate reports. Imposing reporting requirements on approved participants could enable the mortgage insurer to conduct off-site monitoring.

The FDIC has also found it essential that its monitoring authority include the ability to create standards to determine whether there has been a change in ownership, which can alter a bank's risk profile.

Authority To Take Enforcement Action

Ongoing monitoring allows the FDIC to identify risks in the banking sector, but we also have explicit statutory authorities that allow us to take action when an institution is engaging in potentially unsafe and unsound practices. Supervisors of FDIC-insured institutions have a wide array of formal and informal enforcement actions to ensure compliance with rules and standards and to correct problematic practices or conditions before a bank becomes insolvent and causes a loss to the DIF. Informal enforcement actions can take the form of memoranda of understanding or Board resolutions. Section 8 of the FDI Act gives the FDIC the authority to pursue formal enforcement actions and civil fines against institutions, their affiliates and certain individual actors, after notice and an opportunity for a hearing. These actions include cease and desist orders, civil money penalties (CMPs), Prompt Corrective Action (PCA) Directives, written agreements, and, ultimately, termination of deposit insurance. The FDI Act also grants the authority to take actions against bank-affiliated individuals including removal and prohibition orders to prevent their participation in the financial services industry for certain misconduct and violations. Providing similar authorities to the Federal mortgage insurer might enable it to correct problem situations before they result in a loss to its insurance fund.

While they are valuable supervisory tools in certain circumstances, provisions for suspension or revocation of the approved status of participants or the ability to impose CMPs are not sufficient alone as tools for effective risk management. Providing monitoring authority and authorizing a broader array of informal and formal corrective actions would enhance the mortgage insurer's ability to take corrective actions prior to losses being incurred.

Insurance Pricing

The FDIC has had experience over its history with both flat rate and risk-based pricing for insurance. Initially, Congress directed the FDIC to charge all banks the same assessment rate. This flat-rate system lasted for 60 years, but it had problems which became evident in the late 1980s when banks started to fail in large numbers. The flat-rate system resulted in less risky banks excessively subsidizing riskier banks and did nothing to reduce the incentives for banks to take excessive risk.

In response to the banking crisis of the late 1980s, Congress ended the flat-rate system in 1991 and directed the FDIC to adopt a risk-based assessment. Since 1993, the FDIC has had a risk-based pricing system where banks that take on more risk pay more in deposit insurance assessments. An important feature of the risk-based pricing system is that it is forward looking. Since the system relies on measuring the likelihood that a bank could fail and cause a loss to the insurance fund, it is inherently more complex than a flat-rate system. To more accurately price for risk, the FDIC must collect a wide range of financial and supervisory information, which it does through quarterly financial reports prepared by banks as well as monitoring and supervising insured institutions.

The FDIC supports a risk-based pricing structure for deposit insurance. However, deposit insurance may not be perfectly analogous to Federal mortgage insurance. A Federal mortgage insurer is likely to have a greater ability to mitigate risk at the outset, for example, by setting robust underwriting standards for the underlying mortgages.

Funding

Funding arrangements also play a critical role in the success of an insurance system, including the FDIC's deposit insurance system. A well-designed system ensures that adequate funds are readily available to respond to problems as they arise and to avoid delays in closing failed banks or paying insured depositors. These arrangements also determine the amount and the timing of the industry's contribution toward the costs of insurance and the degree of taxpayer exposure.

The Importance of Prefunding

The FDIC has always had an explicit, ex ante fund paid for by the banking industry to satisfy claims as they arise. Alternative arrangements, such as pay-as-you-go or ex post assessments, increase the risk that bank closings will be delayed. Delays in closing failing institutions (as the FDIC observed through the experience of the failed Federal Savings and Loan Insurance Corporation) increase the ultimate cost of failure and undermine confidence in the banking system more generally. Prefunding for future losses is also more equitable. With a pay-as-you-go or ex post system, surviving banks pay the costs generated by those that fail, which penalizes those banks that are less risky.

Prefunding also allows an insurer to smooth the cost of insurance over time. The FDIC works to charge steady premiums and avoid procyclical pricing, where rates increase in difficult times—when banks can least afford to pay them and when those funds are most needed to lend and promote economic growth. Most bankers indicate that they prefer steady, predictable premiums rather than procyclical rates. Finally, as with any insurance arrangement, an ex ante fund is reassuring to depositors and taxpayers, thereby promoting confidence and enhancing financial stability.

The Challenge of Determining the Size of the Fund

The question of whether to have an ex ante fund is easier to answer than the question of fund size, which involves balancing significant trade-offs. The FDIC balances the need for a fund that is sufficient at all times to pay depositor claims against the possibility of holding funds that could be better used by banks for lending.

Over its history, the FDIC has experienced mixed success with various approaches to determining an optimal fund size. For more than 50 years, Congress set premium rates and there was no official target fund size, so the reserve ratio (the ratio of the amount in the DIF to estimated insured deposits) fluctuated considerably. This period coincided with great economic stability and few bank failures, so deposit insurance fund adequacy was not a pressing concern.

That situation changed during the late 1980s as the U.S. experienced a large number of bank and thrift failures and large losses to both the banking industry and taxpayer. To address concerns about the viability of the deposit insurance fund in the aftermath of these losses, Congress made a series of changes to the FDIC's authorities for managing the size of the fund. In 1989, Congress instituted for the first time a target for the size of the fund, called a Designated Reserve Ratio (or DRR), which was initially equal to at least 1.25 percent of estimated insured deposits. [1]

[1] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

In 1991, Congress required that, when the fund was below 1.25 percent, the FDIC would be required to raise assessment rates to reach the target within 1 year or charge very high rates, even in periods of economic distress.[2] In 1996, shortly after the reserve ratio reached its target, Congress prohibited the FDIC from charging well-capitalized and well-managed banks anything whenever the fund was at or above that target.[3] The resulting hard target left the FDIC with almost no ability to let the size of the fund materially increase or decrease.

This framework created a number of problems including:

- a decade during which at least 90 percent of the industry paid nothing for deposit insurance,
- a free-rider problem where new entrants and fast growers diluted the fund but paid nothing, and
- potentially volatile and procyclical premiums.

In 2006, Congress removed the hard target and allowed the FDIC to manage the fund within a range of 1.15 and 1.50 percent of estimated insured deposits.[4] Unfortunately, the recent crisis came soon after these changes were enacted and bank failures again caused the fund to become negative. To prevent a repeat of these problems, the Dodd-Frank Act increased the minimum reserve ratio to 1.35 percent and removed the hard cap, which had required that the FDIC return to the industry all amounts that would cause the reserve ratio to exceed 1.50 percent. This new authority effectively allows the FDIC to determine the optimal target, so long as it is at least 1.35 percent of estimated insured deposits.[5] Some flexibility in determining a target fund size may be beneficial for the Federal mortgage insurer, preventing it from facing challenges similar to the fund management problems the FDIC faced in its past.

Striving for Countercyclical Funding

Given its expanded authority, the FDIC has a number of options to choose from in determining an optimal size for its fund. The FDIC has explored sophisticated approaches that draw upon the portfolio management techniques and best practices used by other financial institutions that have to manage capital and financial risks.[6] The appeal of these model-based approaches is the promise of greater rigor and precision in determining potential losses and an optimal fund size. However, model-based approaches pose a host of practical challenges. It is difficult, for example, to accurately determine relationships between economic variables and the variables affecting a bank's failure or to project economic events.

Therefore, in the end, the FDIC took a different approach to determine the most appropriate fund size, one grounded in the agency's actual financial experience. Having experienced two banking crises in the past three decades, it looked at the costs associated with these crises to address two related questions. First, how high did the fund need to grow to prevent it from ever going negative? And, second, what steady premium rates would have been required to achieve the desired balance? The analysis revealed that if the DIF had been allowed to grow to at least 2 percent of insured deposits prior to each of the two preceding banking crises, a steady average premium rate of a little over 8 cents per $100 of domestic deposits would have been required to meet these goals. This approach would have avoided the procyclicality that resulted in volatile premium rates, which necessarily increased during periods of bank failures.

This straightforward approach remains the underpinning of FDIC's current fund management strategy. It was used to set a long-term reserve ratio goal (DRR) of 2 percent in 2011 which continues today. This 2 percent target is viewed as a soft, rather than hard, target. While the FDIC has set rates to achieve the statutorily required 1.35 percent minimum reserve ratio, there is an explicit plan to reduce

[2] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[3] Deposit Insurance Funds Act of 1996, Pub. L. No. 104-208, 60 Stat. 446 (1996).

[4] Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109–171, 120 Stat. 9 (2006).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] The FDIC developed a Loss Distribution Model, which views the deposit insurance fund as a portfolio of credit risks, representing exposure to different banks. For each bank, a probability of failure, loss given failure, and exposure upon failure were estimated to arrive at an expected loss for that bank. An economic model determined the statistical relationships among these elements of expected loss and economic variables such as interest rates, stock price indices, and housing prices. Finally, a simulation model was incorporated to determine a wide range of economic events and produce a distribution of possible future failures and losses to the deposit insurance fund.

rates gradually, but not to zero, if the fund exceeds the long-term 2 percent target. In determining an optimal size for a fund for mortgage insurance, similar trade-offs and historical experiences may be considered.

Successful Transition of Assets From One Entity to Another

The FDIC has unique experience with transitioning the assets and responsibilities of one entity to another. In response to the savings and loan crisis of the late 1980s, Congress dissolved the insolvent Federal Savings and Loan Insurance Corporation (FSLIC), and divided the duties of resolving the crisis between the FDIC and a temporary agency, the Resolution Trust Corporation (RTC). As the RTC was intended to be a temporary agency to address that specific crisis, Congress set a statutory termination date of December 31, 1995, and provided for the transfer of RTC's responsibilities to the FDIC.

A number of factors contributed to the successful transition from the RTC to the FDIC. The resolution authorities and activities of the RTC and FDIC were very similar. The assets from failed savings and loan institutions resolved by the RTC were very similar to the assets of failed banks and savings and loan institutions being handled by the FDIC. In addition, both agencies shared similar policies, procedures, and organizational structures. The employees handling many of the RTC assets ultimately transitioned to the FDIC along with the assets.

Even with these similarities, the FDIC and RTC managements engaged in extensive and cooperative planning for the transition to ensure the continuity of operations. The remaining RTC assets were managed and accounted for in a separate fund as they were wound down. The FDIC/RTC experience may provide some analogies to the housing finance reform, but other aspects of the reform are more complex. Transition in this context involves two large organizations in conservatorship with various assets and liabilities transferring partly into Federal hands, with other assets potentially being sold into the private sector.

Conclusion

Again, thank you for the opportunity to share with the Committee the FDIC's experience and insights regarding the elements essential for a Federal insurance program. As noted at the outset, our history may provide relevant lessons as the Committee contemplates the creation of a Federal mortgage insurance entity. The FDIC has benefited from explicit statutory authority, risk monitoring and control tools, appropriate pricing of insurance, and adequate funding arrangements. We are happy to provide any assistance that the Committee would find valuable as it continues its important work to address housing finance reform.

PREPARED STATEMENT OF KURT REGNER

ASSISTANT DIRECTOR, ARIZONA DEPARTMENT OF INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

NOVEMBER 21, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify today. My name is Kurt Regner, and I serve as the Assistant Director, Financial Affairs Division of the Arizona Department of Insurance. Arizona sits on the Mortgage Guaranty Insurance Working Group of the National Association of Insurance Commissioners (NAIC), and it is on behalf of the NAIC that I present this testimony today.

The NAIC is the United States' standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 States, the District of Columbia, and five U.S. territories. Through the NAIC, we establish standards and best practices, conduct peer review, and coordinate our regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of State-based insurance regulation in the United States.

State insurance regulators appreciate the opportunity to offer our expertise and perspective on Federal efforts that impact our system of supervision. As the prudential regulators of insurance, we are in the business of protecting insurance policyholders and ensuring competitive insurance markets. As insurance markets evolve, State insurance regulators remain extensively engaged with all relevant stakeholders to promote an optimal regulatory framework and mortgage insurance is no exception. In that arena, we are very mindful of the need to carefully balance solvency standards with ensuring the availability of coverage in the market. We also appreciate the strong desire in Congress to address a number of issues arising from the mortgage transaction, but want to ensure that any legislation appropriately considers the existing regulatory regime that is designed to meet these important objectives.

Today, I will provide the Committee with an overview of the private mortgage insurance (PMI) market, how participants are regulated by State insurance departments, and highlight actions underway at the NAIC and in the States. I will touch on related issues with respect to financial guaranty insurers, although this is not an area of my expertise. I will also offer impressions on how our regulation can fit in with the objectives of recent legislative proposals.

History of Private Mortgage Insurance

Any discussion of PMI should begin with an understanding of how the industry has evolved over time. The PMI industry dates back to the 1880s, when mortgage banks were first formed to finance loans to people securing land in the Midwest and West. Then as now, PMI promotes home ownership by facilitating the flow of credit from lenders and investors who might not otherwise have the capacity or desire to assume incremental credit risk. PMI enables those lenders to mitigate default risk when a borrower makes a smaller downpayment, which inherently increases the risk of loss.

The PMI industry went bankrupt and disappeared for some time following the Great Depression and the housing collapse of the early 1930s, but reemerged in the late 1950s as alternatives to the Federal Government's Federal Housing Administration (FHA) and Veterans' Affairs (VA) mortgage insurance programs. State insurance regulators, understanding the lessons of the 1930s collapse, saw the need for stronger laws and regulations to ensure PMIs were equipped to handle economic shocks for all the tail risk (i.e., the least likely yet most severe risk) they carry. Since then, the PMIs have faced and largely managed episodes of severe stress in the 1980s, early 1990s, and most recently with the housing crisis a few years ago.

Through the most recent financial crisis, the financial sector's collective assumptions about the housing market were proven wrong. As regulators, we recognized that regulatory requirements for mortgage insurers need to be enhanced to address the risks uncovered by the crisis. Today, the downturn's effects are clearly still being felt by PMI providers, although market and economic trends have generally stabilized in the last couple of years. The PMIs continue to suffer losses from the 2005–2007 books of business as some consumers continue to struggle with their mortgages. However, new defaults should keep trending downward assuming a continued housing and economic recovery; and newer, better priced, and higher credit quality business will continue to strengthen the PMIs. While the main players in the PMI space survived the crisis, they are recovering slowly as they try to improve their financial situations. We have been in the process of adjusting regulatory requirements to address the risks uncovered by the crisis. We have also been keenly focused on improving the competitive landscape for the mortgage insurance market by ensuring that opportunities exist for new market entrants and that our supervisory framework does not undermine the availability of coverage for new homeowners and the lenders that service them.

How Private Mortgage Insurance Works

At its most basic level, mortgage insurance underwrites the risk of borrowers defaulting on their loans. The borrower pays the premiums, and the lender is the beneficiary of the policy. PMI premiums are paid either in monthly installments or a single premium payment at loan origination. Unlike FHA or VA loans, the amount of loss coverage is usually capped as a proportion of lost loan principal, usually between 20 to 30 percent of the loan balance.

Generally, mortgage insurers provide coverage in four basic forms: flow insurance, bulk insurance, pool insurance, and reinsurance.

- Flow insurance provides coverage on an individual loan basis and is purchased at the time a loan is originated. The lender selects the carrier, but the cost is paid by the borrower.
- Bulk insurance provides coverage on each loan in a larger group of loans that have already been originated. These loans may have flow insurance already, in which case the bulk provides a second layer of protection against losses.
- Pool insurance provides coverage of multiple mortgages, generally in connection with mortgage securitizations. Insurers provide coverage for losses up to an aggregate limit.
- Private mortgage reinsurance, in which the primary insurer passes a portion of the risk to a third party insurer, has generally been written by "captive" reinsurers affiliated with lenders.

Supervision of Mortgage Insurers

PMIs are regulated by the States in which they do business, with the State of domicile providing primary regulatory oversight. Each domestic State conducts financial oversight of the companies operating in its jurisdiction. State laws and regulations that are specifically tailored for mortgage insurance control the risk PMIs can assume through a variety of limitations, including reserve requirements, capital requirements, investment and risk concentration restrictions, and restrictions on nonmortgage insurance related activities.

PMIs are required to file all policy forms and premium rates with State insurance departments, and must also file audited financial statements, prepared in accordance with statutory accounting principles (SAP) developed by insurance regulators.

The NAIC has a Mortgage Guaranty Model Act that has been adopted in substantial form by all the States primarily responsible for the regulation of mortgage guaranty insurers.[1] As I alluded to previously, the NAIC is in the process of making adjustments to this model and it is anticipated that these States will adopt the new version of the model.

Capital Requirements

PMIs are generally required to maintain risk-to-capital ratios not exceeding 25 to 1. Most State regulators are authorized to exercise discretion in administering this requirement.

State regulators are currently considering modifying the NAIC model to replace the 25 to 1 risk-to-capital ratio with a more refined capital requirement. This includes most notably, conformance with a risk-based capital formula to be developed for mortgage guaranty insurers. Regulators are also considering a separate loan level cash flow projection capital model requirement if the risk-based capital formula falls below the required threshold.

In addition to the capital ratio requirements, there are minimum capital requirements. Currently, PMIs cannot transact the business of mortgage guaranty insurance unless, if a stock insurance company, it has paid-in capital of at least $1 million and paid in surplus of at least $1 million, or if a mutual insurance company, a minimum initial surplus of $2 million. A stock company or a mutual company must maintain a minimum policyholders' surplus of at least $1.5 million. State regulators are currently considering modifying the NAIC model to increase the required paid in capital and paid in surplus to $10 million and $15 million, and at all times thereafter a minimum policyholders' surplus of at least $20 million.

As a practical matter, the minimum capital and surplus requirements are chiefly of importance in the technical details of organizing or reorganizing a PMI. Under the business plans of PMIs that are in business or in the process of being organized, a PMI writing business on a direct basis requires hundreds of millions or billions of dollars in capital and surplus.

Reserve Requirements

As I mentioned earlier, PMIs have significant reserve requirements to protect against economic shocks, given the large amount of tail risk they carry. PMIs maintain up to four separate reserve components:

1. *Unearned premium reserves:* This reserve requirement reflects the amount of premium for the portion of the insurance coverage that has not yet expired.
2. *Contingency reserves:* This is a long-term, countercyclical regulatory capital requirement. PMIs contend with cyclical volumes of claims that generally stay within certain parameters but occasionally spike, with potentially significant consequences. This risk is kept in check by requiring PMIs to keep in reserve 50 percent of net earned premiums for 10 years in anticipation of larger defaults. These reserves are built over time and drawn down only when losses exceed statutory thresholds (typically 35 percent of premiums or more) or State regulators authorize special releases.

   This requirement is also in place to prevent excessive dividends or otherwise dissipating reserves that might be needed to pay claims in a highly adverse loss scenario.
3. *Loss reserves:* This is a short-term regulatory reserve requirement. Sometimes called "case basis loss reserves," these must equal expected losses on delinquent loans of which the insurer is aware.
4. *Premium deficiency reserves:* This reserve is established when anticipated losses plus related expenses exceed expected future revenue. It is intended to

[1] NAIC Model Act #630-1. Attached as Appendix A.

cover potential losses from all business in force, since mortgage insurers can be responsible for future losses.

Contingency reserves are intended to be built up over good times in stable markets, so that when the housing market slumps and PMI is most needed, the providers will be well-positioned to pay out claims.

State regulators are currently considering modifying the NAIC model to increase the risk sensitivity of the contingency reserves previously mentioned.

Coverage, Investment, and Geographic Restrictions

Coverage provided by mortgage guaranty insurers ceded is limited to 25 percent of the entire indebtedness to the insured.

Insurance regulators also place limits on the ability of a PMI to invest in any particular security, and while they can invest in stocks, bonds, notes, and other instruments, they may generally not invest in real estate.

PMIs are not allowed to insure loans that are individually in excess of 10 percent of the company's aggregate policyholders' surplus and contingency reserves. Also, PMIs are prohibited from having more than 20 percent of total insurance in force in any one "Standard Metropolitan Statistical Area", as defined by the United States Department of Commerce.

These concentration limitations are intended to protect against sector and regional housing slumps—it enables PMIs to use premiums collected in more stable regions to offset losses incurred in distressed markets. It is worth noting here that the broad geographic scope of the housing crisis illustrates the unique challenge for PMIs. Geographic spreading of the risk is an effective tool, for example, for property insurance where natural disasters and economic events are not necessarily correlated. However, the 2008 crisis illustrated that lending risk can be correlated at the extremes, so there are unique challenge that PMIs and regulators must manage to address the unique characteristics of this product.

Nonmortgage Activities

PMIs are "monolines" and generally may not engage in activities other than mortgage related insurance because of the unique type of insurance risks involved. Unlike insurance designed to protect against loss of life or property, the risks faced by PMIs are directly correlated with the housing market and economic conditions. Although monolines are subject to unique risks, they are not exposed to the multitude of risks that a multiline writer is exposed to protecting the monoline writer from risks that they do not underwrite. However, PMIs may be affiliated with a variety of other types of businesses that do write other types of insurance or engage in other types of financial services.

Recent Trends in the PMI Market

Next, let me to turn to discussing the state of the PMI market. The financial crisis found PMIs exposed on the front lines—after all, they were the ones directly underwriting the risk of borrowers defaulting on their loans. Since PMIs provided coverage on high loan-to-value mortgages with very thin equity slices, they were vulnerable to potential losses in the event of rising delinquencies and defaults. [2]

The PMI industry recorded its best year in terms of new insurance volume in 2007, with total new insurance written exceeding $300 billion for the first time. [3] A short 2 years later, new insurance written had declined to $81 billion as the market for mortgage insurance shrunk, following the collapse of the housing market and the subprime crisis. As home prices plummeted, the wave of mortgage defaults and home foreclosures weakened mortgage insurers' capital position as a result of substantial losses. Having to set aside substantial capital to cover future claims severely constrained mortgage insurers' ability to write new business. The very challenging market conditions that the mortgage insurance industry experienced since the eruption of the crises are reflected in the sharp rise of the industry's loss and combined ratios. The industry's loss ratio (losses over net premiums earned) jumped from 41 percent in 2006 to a record high 218 percent in 2008. [4]

[2] Center for Insurance Policy Research. "Financing Home Ownership: Origins and Evolution of Mortgage Securitization—Public Policy, Financial Innovations, and Crises". August, 2012. *http://www.naic.org/cipr*

[3] Mortgage Insurance Companies of America (MICA). "2012–2013 Fact Book and Member Directory".

[4] Mortgage Insurance Companies of America (MICA). "2012–2013 Fact Book and Member Directory".

As of year-end 2012 there were a total 34 active monoline writers of mortgage guaranty products within 9 insurance groups. Of these 9 insurance groups, 7 groups accounted for 95.7 percent of gross mortgage guaranty premiums.

Gross premiums written for monoline mortgage guarantors have fluctuated over the past 5 years from low of $4.9 billion in 2012 to a high of $7.4 billion in 2008. Gross paid losses peaked in 2010 at $12.9 billion (77.4 percent of which was reported within the six largest guarantors) compared to $2.8 billion for 2007. Contingency reserves were nearly exhausted over the past 5 years, totaling $221.4 million at year-end 2012 compared to $13.4 billion in 2007.

It is also worth noting that today, most residential mortgages insured by PMIs are sold to Fannie Mae and Freddie Mac, the Government-Sponsored Enterprises (GSEs). They have a statutory requirement to obtain credit enhancement on single-family residential mortgages purchased with loan-to-value ratios of over 80 percent. PMI is the major credit enhancement they use. [5] A recent study on the role of PMI explained that in addition to the regulatory structure, PMIs are preferable to other credit enhancements because of lender diversification, delayed losses, and acquaintance with the risks. [6] However, in the event the GSEs are wound down, it is unclear how PMI providers will be affected.

Although market and economic trends appear to have generally stabilized in the last couple of years, this trend has not yet helped mortgage insurers to materially improve their financial situation. Many mortgage insurers have been able to obtain additional capital, but the losses were material enough that it's expected to take additional time to fully recover.

Mortgage Guaranty Insurers* - As of December 31, ($ in Millions)

	2012	2011	2010	2009	2008
Policyholders' Surplus	$3,223	$3,813	$7,852	$6,527	$5,606
Contingency Reserves	$201	$605	$613	$2,793	$7,135
Gross Premiums Written	$4,841	$5,201	$5,591	$6,248	$7,421
Net Premiums Written	$3,914	$4,205	$4,235	$4,544	$5,370
Net Income (Loss)	($1,740)	($4,986)	($2,460)	($2,908)	($4,954)
Cash From Operations	($2,078)	($5,597)	($3,511)	($900)	$575

* Includes only pure mortgage guaranty writers (only writing MG)

State Regulators' Ongoing Efforts To Make Adjustments to MI Regulations

State insurance regulators are actively studying what changes are deemed necessary to the solvency regulation of mortgage guaranty insurers. The NAIC's Mortgage Guaranty Insurance (E) Working Group was formed by the Financial Condition (E) Committee in late 2012. This Working Group is assessing what changes should be made to the Model Act, and each of the previously mentioned potential changes have been developed by this NAIC group.

In February 2013, the Working Group released a list of potential regulatory changes in which it identified the issues with mortgage guaranty insurance as it exists now. The primary problems are threefold:

1. The overconcentration of mortgage originations in only a few banks has increased the pressure on mortgage insurers to accept everything given to them by any single bank or risk losing all the business from that bank.
2. The cyclical nature of mortgage insurance means that periods of high profitability are followed by periods of varying duration of catastrophic loss.
3. The lack of incentives to continue adhering to strict underwriting standards during booming periods when there is no threat of discontinued business.

In addition to the previously mentioned potential changes to the NAIC model and a new Risk Based Capital formula specific to Mortgage Insurance, the following additional potential changes are being considered:

[5] GAO Report: "FHA Mortgage Insurance: Applicability of Industry Requirements Is Limited, But Certain Features Could Enhance Oversight". September, 2013.

[6] Promontory Financial Group, LLC, "The Role of Private Mortgage Insurance in the U.S. Housing Finance System". January, 2011.

- The need for new reporting requirements that break out mortgage insurers' exposures to different levels of risk and are used as partial input into the minimum capital requirements.
- The need to prohibit captive reinsurance agreements between mortgage insurers and originating banks.
- The need to refer potential accounting issues to the NAIC's Statutory Accounting Principles (E) Working Group for further consideration as a longer-term project than what the Working Group is focused on currently.

The Working Group's next steps are to expose a concept draft of a new model for public comment and debate.

Financial Guaranty Insurance

I understand that you are also interested in bond insurers (also known as "Financial Guarantors"). Since Arizona is not a domestic regulator for a financial guarantor, I have limited expertise in the area and encourage the Committee to discuss the regulation of these insurers with a State that regulates one of the remaining financial guarantors. Nevertheless, as an experienced insurance regulator, I do have some thoughts on the state of the industry. Bond insurers are distinct from other property casualty insurers. Their business is based almost exclusively on selling their credit rating to other parties. This niche industry developed in the early 1970s and initially focused on wrapping AAA ratings around lower-rated municipal obligations for a small fee. Bond insurance benefited municipalities by both increasing the market for their bonds and lowering their net costs. In the 1990s, bond insurers expanded their business into structured products like Asset Backed Securities, Credit Default Swaps, and Collateralized Debt Obligations. These more complicated investment vehicles, some of which were tied to subprime-backed mortgages, exposed bond-insurers to greater risk, which became painfully evident during the financial crisis.

Since the crisis, the structured bond insurance market has basically dried up. The bond industry struggled to remain relevant following the 2008 economic crisis and ensuing housing crash. The industry declined to only two affiliated active writers, who are only writing coverage on traditional municipal business, and are rated AA—by Standard and Poor's.

Gross written premiums for monoline financial guarantors have steadily fallen over the past 5-year period, from $4.4 billion in 2007 to $1.2 billion at year-end 2011. Gross paid losses peaked in 2009 at $10.8 billion (mostly due to the four large insurers), compared to $110.6 million for 2007, with reported losses of $3.4 billion at year-end 2011. Contingency reserves totaled $6.1 billion at year-end 2011 compared to $8.7 billion for 2007, before the financial crisis started.

On a positive note, this has opened the door for new participants, as newly established insurers and surviving players compete to meet the continued demand for bond insurance for municipal obligations. There have been two recent entrants who have written $8 million in traditional municipal business as of mid-year 2013—one is rated AA—and the other is rated AA by Standard and Poor's. The 2008 crisis dramatically illustrated the risk inherent to many of the structured products linked to the mortgage market that financial guarantors were seeking to insure.

Current Legislative Proposals

State regulators working through the NAIC recognize the important role that PMI continues to play in the housing market and the role that recent legislative proposals contemplate the PMIs and the financial guarantors playing in that market. While, at this time, the NAIC has not taken a position on any of these legislative proposals including S.1217, the bipartisan Housing Reform bill introduced by Senators Corker and Warner, we certainly appreciate the need for and the efforts by Congress to address the issues that arose during the financial crisis with the housing finance system and the GSEs. We recognize that there are many who would like a more prominent role for the private market in housing finance markets and less reliance on the GSEs, and insurance regulators remain committed to helping Congress shape such proposals.

However, any effective proposal needs to take into account the existing regulatory regime and the lessons State insurance regulators learned during the crisis. In this regard, we caution against solutions that solely or substantially rely on the use of private mortgage insurers and financial guarantors as the lubricant for the housing market engine. Private mortgage insurers appropriately insure individual loans and, to date, there has been little experience with their insuring securities. Indeed, there may be regulatory concerns with expansion into this business as they could in some cases take on risks in the same loan or type of loan as both a guarantor of the securities and the insurer of the individual loan. Conversely, financial guarantors have substantial experience in the area but failed to live up to expectations during financial crisis and, given our experience to date, insurance regulators remain skeptical of their capability of insuring anything other than municipal debt—particularly if the underlying financial instrument they seek to insure is not appropriately capitalized and secure. Reliance on these entities should not be considered the "magic bullet" that will fix the housing finance market. Moreover, throughout this process, neither PMI nor financial guaranty insurance should be seen as a substitute for due diligence or sound underwriting by mortgage servicers or bond issuers.

The NAIC is concerned with proposals for a new Federal regulator with the authority to develop, adopt, and publish standards for the approval of insurers that provide first loss coverage for individual loans (such as the PMIs) or provide coverage for eligible bonds. While insurance regulators recognize that any new Federal entity charged with establishing and maintaining the requirements surrounding a Government guarantee has a strong interest in ensuring that taxpayers are not left with the bill, appropriate deference should be given to existing State insurance regulatory requirements such as capital and reserving requirements that are designed with the dual purpose of protecting policyholders and ensuring competitive insurance markets. The incentive is simply too great for a regulator charged with maintaining the viability of a Government guarantee to overshoot this regulatory objective and put in place standards, particularly solvency standards such as capital requirements, that are more stringent than necessary. This would ultimately threaten the availability of coverage and undermine the objective of a private market solution to support a vibrant housing market for the future.

We would propose that any new Federal entity defer to the State regulators' supervision of the companies within their purview, which are designed to protect policyholders and ensure availability of coverage. Instead, the focus should be on establishing standards for any unregulated entities that may participate in the housing finance framework and create standards relating to the establishment and administration of any new Government guarantee. If there are issues of common concern that arise, Federal regulators should work hand in hand with the insurance regulators to address them, as is done today with the Federal Housing Finance Administration, the Federal Reserve, and the other Federal financial regulatory agencies.

Conclusion

As the GAO recently affirmed, U.S. insurance regulators have a strong track record of effective supervision of insurers, even in the face of the worst financial crisis since the Great Depression.[7] The NAIC and State regulators are committed to working alongside Congress and Federal banking regulators to help ensure open, competitive, and stable housing and mortgage insurance markets that promote investment in home ownership while protecting both lenders and borrowers.

The NAIC looks forward to contributing meaningful input as insurers, lenders, borrowers, policyholders, and the Federal Government work together to develop a new framework for housing regulatory structure in the U.S. Together, we will meet any new challenges posed by a dynamic housing market. We remain committed to effective regulation of the PMI and financial guaranty industries, and to making changes to our regulatory structure where necessary. We continue to believe that well-regulated markets make for competitive markets and well-protected policyholders.

Thank you again for the opportunity to be here on behalf of the NAIC, and I look forward to your questions.

[7] GAO Report 13-583: "Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis". June 2013.

APPENDIX

MORTGAGE GUARANTY INSURANCE MODEL ACT

Table of Contents

Section 1. Title

This Act may be cited as the Mortgage Guaranty Insurance Act.

Section 2. Definitions

The definitions set forth in this Act shall govern the construction of the terms used in this Act but shall not affect any other provisions of the code.

A. "Authorized real estate security," for the purpose of this Act, means an amortized note, bond or other evidence of indebtedness, not exceeding ninety-five percent (95%) of the fair market value of the real estate, secured by a mortgage, deed of trust, or other instrument that constitutes, or is equivalent to, a first lien or charge on real estate; provided:

(1) The real estate loan secured in this manner is one of a type that a bank, savings and loan association, or an insurance company, which is supervised and regulated by a department of this state or an agency of the federal government, is authorized to make, or would be authorized to make, disregarding any requirement applicable to such an institution that the amount of the loan not exceed a certain percentage of the value of the real estate;

(2) The improvement on the real estate is a building or buildings designed for occupancy as specified by Subsections A(1) and A(2) of this section; and

(3) The lien on the real estate may be subject to and subordinate to the following:

(a) The lien of any public bond, assessment or tax, when no installment, call or payment of or under the bond, assessment or tax is delinquent; and

(b) Outstanding mineral, oil, water or timber rights, rights-of-way, easements or rights-of-way of support, sewer rights, building restrictions or other restrictions or covenants, conditions or regulations of use, or outstanding leases upon the real property under which rents or profits are reserved to the owner thereof.

B. "Contingency reserve" means an additional premium reserve established to protect policyholders against the effect of adverse economic cycles.

C. "Mortgage guaranty insurance" is:

(1) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, provided the improvement on the real estate is a residential building or a condominium unit or buildings designed for occupancy by not more than four families;

(2) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, providing the improvement on the real estate is a building or buildings designed for occupancy by five (5) or more families or designed to be occupied for industrial or commercial purposes; and

(3) Insurance against financial loss by reason of nonpayment of rent or other sums agreed to be paid under the terms of a written lease for the possession, use or occupancy of real estate, provided the improvement on the real estate is a building or buildings designed to be occupied for industrial or commercial purposes.

Section 3. Capital and Surplus

A mortgage guaranty insurance company shall not transact the business of mortgage guaranty insurance unless, if a stock insurance company, it has paid-in capital of at least $1,000,000 and paid-in surplus of at least $1,000,000, or if a mutual insurance company, a minimum initial surplus of $2,000,000. A stock company or a mutual company shall at all times thereafter maintain a minimum policyholders' surplus of at least $1,500,000.

Section 4. Insurer's Authority to Transact Business

No mortgage guaranty insurance company may issue policies until it has obtained from the commissioner of insurance a certificate setting forth that fact and authorizing it to issue policies.

Section 5. Geographic Concentration

A. A mortgage guaranty insurance company shall not insure loans secured by a single risk in excess of ten percent (10%) of the company's aggregate capital, surplus and contingency reserve.

B. No mortgage guaranty insurance company shall have more than twenty percent (20%) of its total insurance in force in any one Standard Metropolitan Statistical Area (SMSA), as defined by the United States Department of Commerce.

C. The provisions of this section shall not apply to a mortgage guaranty insurance company until it has possessed a certificate of authority in this state for three (3) years.

Section 6. Advertising

No mortgage guaranty insurance company or an agent or representative of a mortgage guaranty insurance company shall prepare or distribute or assist in preparing or distributing any brochure, pamphlet, report or any form of advertising to the effect that the real estate investments of any financial institution are "insured investments," unless the brochure, pamphlet, report or advertising clearly states that the loans are insured by mortgage guaranty insurance companies possessing a certificate of authority to transact mortgage guaranty insurance in this state or are insured by an agency of the federal government, as the case may be.

Section 7. Investment Limitation

A mortgage guaranty insurance company shall not invest in notes or other evidences of indebtedness secured by mortgage or other lien upon real property. This section shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contracts of sale are acquired in the course of the good faith settlement of claims under policies of insurance issued by the mortgage guaranty insurance company, or in the good faith disposition of real property so acquired.

Section 8. Coverage Limitation

A mortgage guaranty insurance company shall limit its coverage net of reinsurance ceded to a reinsurer in which the company has no interest to a maximum of twenty-five percent (25%) of the entire indebtedness to the insured or in lieu thereof, a mortgage guaranty insurance company may elect to pay the entire indebtedness to the insured and acquire title to the authorized real estate security.

Section 9. Mortgage Guaranty Insurance as Monoline

A. A mortgage guaranty insurance company that anywhere transacts any class of insurance other than mortgage guaranty insurance is not eligible for the issuance of a certificate of authority to transact mortgage guaranty insurance in this state nor for the renewal thereof.

B. A mortgage guaranty insurance company that anywhere transacts the classes of insurance defined in Section 2A(2) or 2A(3) is not eligible for a certificate of authority to transact in this state the class of mortgage guaranty insurance defined in Section 2A(1). However, a mortgage guarantee insurance company that transacts a class of insurance defined in Section 2A may write up to five percent (5%) of its insurance in force on residential property designed for occupancy by five (5) or more families.

Section 10. Underwriting Discrimination

A. Nothing in this chapter shall be construed as limiting the right of a mortgage guaranty insurance company to impose reasonable requirements upon the lender with regard to the terms of a note or bond or other evidence of indebtedness secured by a mortgage or deed of trust, such as requiring a stipulated down payment by the borrower.

B. No mortgage guaranty insurance company may discriminate in the issuance or extension of mortgage guaranty insurance on the basis of the applicant's sex, marital status, race, color, creed or national origin.

C. No policy of mortgage guaranty insurance, excluding policies of reinsurance, shall be written unless and until the insurer has conducted a reasonable and thorough examination of the evidence supporting credit worthiness of the borrower and the appraisal report reflecting market evaluation of the property and has determined that prudent underwriting standards have been met.

Section 11. Policy Forms and Premium Rates Filed

A. All policy forms and endorsements shall be filed with and be subject to the approval of the commissioner. With respect to owner-occupied, single-family dwellings, the mortgage guaranty insurance policy shall provide that the borrower shall not be liable to the insurance company for any deficiency arising from a foreclosure sale.

B. In addition, each mortgage guaranty insurance company shall file with the department the rate to be charged and the premium including all modifications of rates and premiums to be paid by the policyholder.

C. Every mortgage guaranty insurance company shall adopt, print and make available a schedule of premium charges for mortgage guaranty insurance policies. Premium charges made in conformity with the provisions of this Act shall not be deemed to be interest or other charges under any other provision of law limiting interest or other charges in connection with mortgage loans. The schedule shall show the entire amount of premium charge for each type of mortgage guaranty insurance policy issued by the insurance company.

NOTE: Open rating states may delete a portion or all of this provision and insert their own rating law.

Section 12. Outstanding Total Liability

A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty-five (25) times its capital, surplus and contingency reserve. In the event that any mortgage guaranty insurance company has outstanding total liability exceeding twenty-five (25) times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds twenty-five (25) times its capital, surplus and contingency reserve. Total outstanding liability shall be calculated on a consolidated basis for all mortgage guarantee insurance companies that are part of a holding company system.

Section 13. Rebates, Commissions and Charges

A. A mortgage guaranty insurance company shall not pay or cause to be paid either directly or indirectly, to any owner, purchaser, lessor, lessee, mortgagee or prospective mortgagee of the real property that secures the authorized real estate security or that is the fee of an insured lease, or any interest therein, or to any person who is acting as an agent, representative, attorney or employee of such owner, purchaser or mortgagee, any commission, or any part of its premium charges or any other consideration as an inducement for or as compensation on any mortgage guaranty insurance business.

B. In connection with the placement of any mortgage guaranty insurance, a mortgage guaranty insurance company shall not cause or permit any commission, fee, remuneration or other compensation to be paid to, or received by an insured lender or lessor; any subsidiary or affiliate of an insured; an officer, director or employee of an insured or any member of their immediate family; a corporation, partnership, trust, trade association in which an insured is a member, or other entity in which an insured or an officer, director or employee or any member of their immediate family has a financial interest; or any designee, trustee, nominee or other agent or representative of any of the foregoing.

C. No mortgage guaranty insurance company shall make a rebate of any portion of the premium charge shown by the schedule required by Section 11C. No mortgage guaranty insurance company shall quote any rate or premium charge to a person that is different than that currently available to others for the same type of coverage. The amount by which a premium charge is less than that called for by the current schedule of premium charges is an unlawful rebate.

D. The commissioner may, after notice and hearing, suspend or revoke the certificate of authority of a mortgage guaranty insurance company, or in his or her discretion, issue a cease and desist order to a mortgage guaranty insurance company that pays a commission or makes an unlawful rebate in willful violation of the provisions of this Act. In the event of the issuance of a cease and desist order, the commissioner may, after notice and hearing, suspend or revoke the certificate of authority of a mortgage guaranty insurance company that does not comply with the terms thereof.

Section 14. Compensating Balances Prohibited

Except for commercial checking accounts and normal deposits in support of an active bank line of credit, a mortgage guaranty insurance company, holding company or any affiliate thereof is prohibited from maintaining funds on deposit with the lender for which the mortgage guaranty insurance company has insured loans. Any deposit account bearing interest at rates less than what is currently being paid other depositors on similar deposits or any deposit in excess of amounts insured by an agency of the federal government shall be presumed to be an account in violation of this section. Furthermore, a mortgage guaranty insurance company shall not use compensating balances, special deposit accounts or engage in any practice that unduly delays its receipt of monies due or that involves the use of its financial resources for the benefit of any owner, mortgagee of the real property or any interest therein or any person who is acting as agent, representative, attorney or employee of the owner, purchaser or mortgagee as a means of circumventing any part of this section.

Section 15. Conflict of Interest

A. If a member of a holding company system, a mortgage guaranty insurance company licensed to transact business in this state shall not, as a condition of its certificate of authority, knowingly underwrite mortgage guaranty insurance on mortgages originated by the holding company system or an affiliate or on mortgages originated by any mortgage lender to which credit is extended, directly or indirectly, by the holding company system or an affiliate.

B. A mortgage guaranty insurance company, the holding company system of which it is a part, or any affiliate shall not as a condition of the mortgage guaranty insurance company's certificate of authority, pay any commissions, remuneration, rebates or engage in activities proscribed in Sections 13 and 14.

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves that accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans that have resulted in the conveyance of property that remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period that is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period that is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to fifty percent (50%) of the remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of 120 months, except that withdrawals may be made by the company in any year in which the actual incurred losses exceed thirty-five percent (35%) of the corresponding earned premiums, and no releases shall be made without prior approval by the commissioner of insurance of the insurance company's state of domicile.

If the coverage provided in this Act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company that is properly licensed to provide reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this Act in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this Act.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction in which a mortgage guaranty insurance company subject to the requirement of this Act is also licensed to transact mortgage guaranty insurance require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of the larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this Act.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this Act as required by Subsections A and C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this Act may be computed and maintained as required previously.

Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this Act.

Chronological Summary of Actions (all references are to the Proceedings of the NAIC).

1976 Proc. II 15, 17, 647, 686, 747-753 (adopted).
1979 Proc. I 44, 47-48, 49, 719, 968-969 (corrected).

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PREPARED STATEMENT OF BART DZIVI

CHIEF EXECUTIVE OFFICER, THE DZIVI LAW FIRM, P.C.

NOVEMBER 21, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify on the proposed powers of the regulator and the regulatory structure for the secondary market for housing loans. I have represented many clients in the private sector and the public sector in the nearly 30 years that I have worked on housing finance issues, but my comments today are my own views and are not intended to reflect the views of any of my current or former clients. My views expressed today draw upon my experience with financial institution regulatory agencies, both as a lawyer exposed to the savings and loan crisis two decades ago (where I was involved by first representing the regulators as they pursued various wrongdoing in the western United States and then as counsel to this Committee) and then my recent experience as counsel to the Financial Crisis Inquiry Commission and its review of the housing finance problems at our largest financial institutions.

I commend the Committee for undertaking this hearing, and the other hearings related to the permanent replacement of Fannie Mae (Fannie) and Freddie Mac (Freddie) with a new structure to support housing finance through a vibrant secondary market that relies more on private capital, and presents less risk to the American taxpayer. The prior model of Fannie and Freddie, investor owned companies where the senior managers were given financial incentives to take outsized risks, was deeply flawed public policy. The fact that Fannie and Freddie operated for almost their entire existences without a regulator with the strong supervisory powers like the Federal Housing Finance Agency (FHFA) only exacerbated those flaws. However, uniform standardization in home loans and a national platform for issuing securities provided an efficient means for millions of American homeowners to access affordable credit. Before the advent of what effectively became a national market for mortgage loans, there was a lasting and sustained rate differential on mortgage loans in various regions across the country. [1] The development of a national mortgage market was a significant improvement for rural States that were located far from the centers of capital in the United States.

The Committee should analyze both what was good about Fannie and Freddie for American homeowners, and what was bad about Fannie and Freddie for American taxpayers. I urge the Committee to continue its thoughtful and deliberate approach to this problem because the issues involved are complicated, and the outcomes could have a profound impact on the U.S. economy for generations to come. In the fall of 2008, Congress was faced with a crisis and immediate action was needed to stabilize the financial system. As a result of the efforts of the FHFA to stabilize the operations of the conservatorships of Fannie and Freddie, currently we are not in a crisis, and Congress has the luxury of time. Finding the right solution is more important than getting a quick solution.

In framing my remarks today, I will use S.1217 as a point of departure. The introduction of S.1217 by Senator Corker and Senator Warner and their bipartisan cosponsors represents an important first step in raising the issue of creating a permanent replacement for Fannie and Freddie. I do, however, believe there are ways in which the structure proposed in that legislation, especially the regulatory structure, could be improved.

Today, I will present my views with respect to the legislation's impact on safety and soundness supervision of the newly proposed Federal Mortgage Insurance Corporations (FMIC), and the various private entities and businesses in the housing finance sector that could be involved in the securitization process. In looking at S.1217, I see two primary structural issues for the Committee to consider regarding the regulatory agency:

> First, and most importantly, what is the appropriate level of safety and soundness supervision of the various private entities, such as the mortgage originators, mortgage servicers, and private mortgage insurers, that will be in business with the FMIC?
>
> Second, is it sufficient that the FMIC be run by a board of Government appointees, or should the FMIC's business of granting a Government guar-

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[1] Indeed, in 1982 the rate differential between the State with the highest mortgage rate and the lowest mortgage rate spiked up to 600 basis points. "The Future of Housing Finance: Who Will Qualify?", Rosen Consulting Group and Ranieri Partners, October 25, 2013, p.5. Available at *http://www.ranieripartners.com/latest-news.*

antee on mortgage securities be subject to safety and soundness oversight by a separate Federal agency?

Safety and Soundness Supervision of Private Business Partners of the FMIC

Under S.1217, the FMIC would be created with multiple responsibilities, including the power to establish a Mortgage Insurance Fund to charge fees to be deposited in a fund, and to issue a full faith and credit Federal guarantee to cover losses on securities insured by private parties, after application of a first loss position by either investors or a guarantor. The FMIC would be governed by a five member board of presidential appointees, subject to Senate confirmation. The FHFA, which has enforcement powers similar to the Federal banking agencies, would be abolished.

Given that a Federal credit guarantee is involved, it is critical that any supervision of the private entities participating in the securitization be in the hands of a strong, independent Federal regulator. During the savings and loan crisis of the 1980s, the country learned the hard way that when providing access to Federal guarantees, it may not be prudent to rely on State legislatures and State regulatory officials, with weak Federal oversight. In the 1980s, Congress allowed States wide authority to set the investment rules for State chartered savings and loans, but allowed them to have access to Federal guarantees for deposit insurance.[2] Before Congress slammed that door shut in 1989,[3] weak State supervisors in just a few States loosened the rules and let a torrent of new operators acquire charters, or buy up existing companies, and then the American taxpayer eventually picked up the tab for $124 billion of losses.[4] State regulators may be appropriate for certain entities, such as companies involved in the life insurance business that are supported by State guarantee funds, but when the fund backing any losses is a Federal fund, and the American taxpayer has exposure, prudence demands that a strong Federal regulator be in charge.

The legislation establishes a process for the FMIC to establish standards for approving private parties doing business with the FMIC. The private parties participating in the securitization process and subject to Government oversight are limited in the legislation to private mortgage insurers, mortgage servicers, bond issuers, and bond guarantors that do business facilitated by the FMIC. The FMIC is given the power to suspend or revoke the authority of those entities to do business with the FMIC, and the power to adopt a civil money penalty process.

I believe this portion of the legislation can be improved substantially by allowing a Federal agency with safety and soundness duties more like the Federal banking agencies to supervise the activities of the private parties participating in the securitization process.[5] I recommend that three specific changes be considered by the Committee.

First, I would broaden the definition of the private parties in the securitization process that are subject to Government oversight, and increase the flexibility of the Federal agency to define by regulation the key mortgage securitization participants that are subject to its authority. The specified entities in the legislation—private mortgage insurers, mortgage servicers, issuers[6] and bond guarantors—should be expanded in the statutory language, and the statute should expressly grant that Federal agency the authority to adopt regulations in the future further expanding the list. For example, it is my view that mortgage originators, due diligence firms, and trustees of the securitization trusts holding the mortgages that are underlying the

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[2] Pub. L. No. 97-320 (Oct. 15, 1982).

[3] Pub. L. No. 101-73 (Aug. 9, 1989).

[4] "Fuzzy Numbers Lead to Prickly Politics", Steve Sloan, *Congressional Quarterly Weekly*, (Oct. 30, 2010).

[5] In my view, the abolition of the FHFA is unnecessary and would add further complications to the transition to a system where Fannie and Freddie are replaced permanently with a new organization. My references to a Federal agency in this section could mean the FHFA if the Committee determined its abolition was unnecessary and made it the safety and soundness supervisor for both the FMIC and the Federal Home Loan Banks. If the Committee determines not to abolish the FHFA, it also could consider whether the single director should be replaced with a three person board.

[6] I believe the Committee should consider an alternative structure where the FMIC itself is the sole issuer of mortgage backed securities. The primary goal in issuing these securities with a Federal guarantee is to have a low cost of funds that is passed onto individuals with home mortgages at a low markup. The structure of the system proposed in the bill would have multiple issuers, and because of the liquidity premium for smaller outstanding issues, such bonds would undoubtedly have a higher interest rates, and a larger bid ask spread, than bonds issued by one large issuer. The FMIC could act as the sole conduit for entities that desire to issue securities, much as the Office of Finance acts as the sole issuer for all the Federal Home Loan Banks. 12 CFR 1273.

guaranteed securities should be subject to oversight by the Federal agency. Securitization trustees occupy a key position from which they could protect investors, but often have little accountability for their actions, and in the past have not shown great vigor in exercising their potential powers. The Federal agency should have the power to take actions that can influence all the key participants in the mortgage securitization market place.

If this new secondary market structure is meant to last, then the Federal agency must be given the power to adapt to changing times and changing financial markets. Otherwise, over time, the agency will be left writing rules applicable to horse drawn buggies as Google-powered self-driving cars cruise the freeways.

Second, I would grant the Federal agency the express power to examine and inspect the books and records of all the entities that participate in the mortgage securitization, and afford the agency examiners who do that inspection the same powers and protections that are afforded to national bank examiners.[7] Federal bank examiners today essentially have unfettered access to all the materials and documents available to the senior managers of the banks they inspect, even materials that are subject to litigation privileges. The Federal examiners need access to this information, which is often in the form of confidential reviews and reports, to fully inform their views, and the private parties need to know that divulging such information does not impair existing litigation privileges.

Third, the proposed legislation grants the FMIC the power to set standards for private parties and suspend them from doing business with the FMIC if they violate those standards. That is a blunt weapon. Instead of relying upon a concept of program suspension for private parties that violate the agency's standards, supplemented with a general grant of power to create a civil money penalty system, I would create an express enforcement system modeled after the Federal banking laws, with the power to take action for violations of law and regulation, and also for engaging in unsafe and unsound practices. That final phrase, "unsafe and unsound practices", is a key weapon in the arsenal of the bank regulatory agencies. It was added to the Federal banking laws in 1966 at the request of the Federal banking regulators and allows them to address developing practices and conditions.[8] The remedies available to the Federal agency in enforcing its authority should include cease and desist powers,[9] temporary cease and desist powers,[10] the power to take action against individuals (referred to as institution affiliated parties) to prohibit such individuals from engaging in further business related to the Mortgage Insurance Fund,[11] and a civil money penalty system with express amounts and tiers similar to those of the Federal banking agencies.[12]

Cease and desist authority allows a Federal regulator to take more precise action than relying upon the blunt action of causing the private business to be barred from doing any further work on mortgage securitizations that have the benefit of a Federal guarantee. Certainly there would be instances in which the offenses do not warrant causing the private entity to be barred from all further work, but nonetheless call for remediation. And, as is the common practice with the Federal banking regulators, instead of actually using the statutory power to issue a cease and desist order, in most instances a consent agreement would be negotiated between the private business and the Federal agency setting forth the scope of the appropriate remedial action. This is a much more effective tool than relying upon the brinksmanship of threatening to bar the private party from engaging in business with the entity providing the Federal guarantee.

Separation of the Business of Guaranteeing the Securities and Supervising the Entity That Makes Guarantees

S.1217 grants the FMIC the power to issue the guarantee of mortgage securities and does not subject the FMIC to supervision by a separate safety and soundness

[7] 12 U.S.C. 481. The relevant criminal code provisions in Title 18 of the United States Code should also be amended.

[8] The broad context of this term was set forth in testimony during legislative hearings that has been accepted by courts as a guiding principle. "Generally speaking, an 'unsafe or unsound practice' embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance fund." Financial Institutions Supervisory Act of 1966, Hearings on S.3158 before the House Committee on Banking and Currency, 89th Cong., 2d Sess. At 49-50 (1966) (statement of Federal Home Loan Bank Board Chairman Horne).

[9] 12 U.S.C. 1818(b).

[10] 12 U.S.C. 1818(c).

[11] 12 U.S.C. 1818(e), (f), and (g).

[12] 12 U.S.C. 1818(i)(2).

regulator. Instead, the legislation creates a board of directors composed of Presidential appointees, and relies upon them to be self policing when extending a Government guarantee on mortgage securities. I am troubled by this framework.

A review of the history of the housing finance system shows why this proposed approach might be troublesome. The recent crisis is not the first time that the housing GSEs have faced significant financial troubles. By 1981, Fannie Mae, which had a Chief Executive Officer that was a presidential appointee, and presidentially appointed members serving on its board of directors, was insolvent on a market value basis.[13] Fannie Mae continued to generate cumulative net losses in 1981, 1982, 1984, and 1985.[14] At that time, Fannie Mae had no independent safety and soundness supervisor with strong enforcement tools; its operations were subject to "light touch" supervision by HUD until Congress created the Office of Federal Housing Enterprise Oversight in 1992.[15] While the specific manner in which Fannie Mae blew a hole in its balance sheet back in the 1980s (holding long term assets in portfolio that it financed with short term debt) would not be available to the proposed FMIC, the similar structural incentives are in place for excessive risk taking. History has shown that merely having a presidentially appointed executive and some presidentially appointed directors did not restrain that organization's push to zealously expand its business.

In the 1980s, there was no strong independent Federal regulator to restrain the Freddie or Fannie business managers' zealous push to expand their book of business. As the GAO said in the early 1990s, the multiple roles given to HUD created an inherent conflict of interest.[16] HUD was a promoter of housing, yet it had a role as safety and soundness regulator of Fannie and Freddie. Multiple conflicts arise in this scenario. HUD's conflict at that time is evidenced by its response to the 1990 GAO report, in which it argued that Fannie's and Freddie's minuscule then existing capital (each had less than 1 percent of capital to back its assets and outstanding mortgage backed securities) was more than enough to meet any stringent capital standards.[17]

In another context, the GAO has previously noted that making operational business decisions and being an arms' length safety and soundness supervisor are incompatible. In 1993, GAO issued a report noting that the Federal Housing Finance Board still had several governance functions with respect to the operations of the Federal Home Loan Banks (such as approving budgets and dividends), and was also charged with being the safety and soundness supervisor of the Federal Home Loan Banks.[18] GAO recommended that safety and soundness supervision should be done by a single independent regulator, and that the governance decisions should be given to the Federal Home Loan Banks and their shareholders.[19] Congress wisely

[13] "Regulating Housing GSEs: Thoughts on Institutional Structures and Authorities", Lawrence J. White and Scott W. Frame, *Federal Reserve Bank of Atlanta Economic Review,* April 2004, fn. 6.

[14] "Government-Sponsored Enterprises: The Government's Exposure to Risks", General Accounting Office, GGD90-97 (Aug. 1990), p.9. Freddie Mac, which in the early 1980s was a subsidiary of the Federal Home Loan Banks and was not investor owned like Fannie Mae was at that time, and Freddie "was consistently profitable throughout the 1980s . . . [avoiding] most interest rate risk . . . and . . . [with] credit losses . . . lower than industry average." Id. at 8. However, Freddie Mac was not subject to stringent safety and soundness standards, and operated with razor thin capital (0.62 percent of its assets and outstanding MBS at the end of 1989). Id.

[15] Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550 (Oct. 28, 1992) Title XIII. Even then, this new agency was hobbled with statutory restrictions giving it far less authority (compared to the Federal banking regulators) to supervise the safety and soundness of Fannie Mae and Freddie Mac.

[16] "Government-Sponsored Enterprises: The Government's Exposure to Risks", General Accounting Office, GGD90-97 (Aug. 1990), p.11.

[17] "Government-Sponsored Enterprises: The Government's Exposure to Risks", General Accounting Office, GGD90-97 (Aug. 1990), p.152.

[18] "Federal Home Loan Bank System: Reforms Needed To Promote Its Safety, Soundness, and Effectiveness", General Accounting Office, GGD-94-38 (Dec. 1993).

[19] Id. at 4-5. Although my testimony today focuses on the FMIC and the supervision of the various private parties with which it will do business, I also would suggest that having the FMIC be responsible for running the Mortgage Insurance Fund, and being the safety and soundness supervisor of the Federal Home Loan Banks raises some conflicts that are parallel to the conflict that were in place when the Federal Home Loan Bank Board was responsible for running the FSLIC insurance fund (that insured savings and loans deposits), and supervising the Federal Home Loan Banks. When the FSLIC was running low on funds to close troubled savings and loans, it lowered collateral standards applicable to FHLBank loans to savings and loans, and pressured them to make loans that they would not otherwise make. I believe the Committee should consider allowing the FHFA to continue to exist, and act as the safety and soundness supervisor for the FMIC, the private parties involved in FMIC securitization, the Federal Home

followed the advice of GAO, and later eliminated the governance powers that the FHFB had previously held.[20]

In the current context, an organization charged with ensuring the availability of mortgage credit to the maximum extent possible will want looser underwriting standards so more families can have access to housing; a safety and soundness regulator will want tighter underwriting standards to prevent losses during economic downturns. This proposed structure puts the FMIC in an inherent conflict of interest. In running the business of guaranteeing securities and setting the standards for the private parties involved in the securitization, they would naturally want the business to expand as much as possible to provide as many benefits to as many American households as possible; a safety and soundness regulator, on the other hand, should want the standards to provide protection to prevent losses when an economic downturn occurs. This fundamental tension is why I believe the roles should be separated into separate organizations.

Some have suggested that the deposit insurance model, with a special purpose Government backed corporation providing a guarantee of insured deposits should provide comfort to those considering the proposed model of the FMIC operating without independent oversight from a separate safety and soundness supervisor. To this I say please examine the results of such specialized deposit insurance systems that have been run by special purpose corporations in the housing finance system: there are some rather spectacular failures. The most famous of these, of course, is the Federal Savings and Loan Insurance Corporation, which collapsed for good in 1989, and caused an enormous loss for the taxpayers.

But the FSLIC failure was not an isolated incident. Into the mid-1980s there were several States that had State laws creating deposit insurance programs funded by assessments on State chartered housing lenders. By 1985, all but one of these programs had failed, or were closed before they failed.[21] Some of these were operated exclusively with State chartered thrift members on the board of directors,[22] and some had directors appointed by the State government.[23] But because none of them charged their members enough for their deposit insurance, they all failed.

Even the fiscal history of the FDIC should not give great comfort to those saying putting Government appointed directors on the board of a governmental entity giving credit guarantees is sufficient protection in all contexts. At the end of 2009, the Deposit Insurance Fund managed by the FDIC had a negative balance of $20.9 billion.[24] One must question whether that negative balance would have been substantially larger but for the extraordinary steps taken in 2008 by Congress, the Federal Reserve, and the FDIC to pump hundreds of billions of dollars into the financial system. Although the FDIC system of deposit insurance has been a dramatic success in protecting small savers and stabilizing the American banking system, there are issues that should cause the Committee to be careful in exporting that model into other areas. In the years leading up to the recent crisis, from 1996 to 2006, the overwhelming majority of banks paid nothing for their deposit insurance from the

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Loan Banks, and its Office of Finance. The Office of Finance issues bonds on behalf of all the Federal Home Loan Banks, and is subject to FHFA enforcement actions because Congress defined it as an entity affiliated party. 12 U.S.C. 4502(11). A graphic depiction of the current regulatory system, the system proposed by S.1217, and an alternative structure are set forth in Exhibits A, B, and C to this testimony.

If the Committee were to adopt the alternative approach, it could consider whether the best way to structure the FMIC's guarantee operations would be as a Government corporation (the GNMA model), or as a member owned cooperative (the FHLBank model). The primary benefit of the industry cooperative model is that it requires the industry to have "skin in the game" in the form of stock purchased in the cooperative in order to do business with the cooperative. It is not clear to me that there would be enough critical mass of business for the mutual securitization company for small companies envisioned by section 215 of the proposed bill to ever begin operation.

[20] Pub. L. No. 106-102 (Nov. 12, 1999).

[21] "Mass. Thrifts To Seek U.S. Insurance", Laurie Cohen, *Chicago Tribune* (May 24, 1985), p.C1 (Ohio, Maryland, North Carolina, and Massachusetts deposit insurance systems were closed in 1985, and only the Pennsylvania Savings Association Insurance Corp. remained open). The Nebraska Depository Insurance Guaranty Corporation had declared bankruptcy in 1983. "After the Ohio bank run, extend Federal insurance to all banks", R. Richardson Pettit, *N.Y. Times* (March 24, 1985), p.2.

[22] The fund established by Ohio had all its directors elected by State thrifts. "The Ohio Deposit Guarantee Fund—The Ohio Alternative to FSLIC", Ronald Alexander, 15 *Akron L. Rev.* 431, 436 (1982).

[23] The ineffectual Maryland Savings-Share Insurance Corp., for example, had three of its board members appointed by the Governor of Maryland. "Toothless Watchdog Shares Blame", R.H. Melton and John Mintz, *Washington Post,* (Dec. 26, 1985) p.A1.

[24] "FDIC insurance premiums not likely to change soon, Gruenberg says", Ken McCarthy, *SNL Bank and Thrift Daily* (Oct. 9, 2013).

FDIC.[25] A former FDIC Chairperson noted in testimony before this Committee over a decade ago that the statutory model then in effect did not allow the FDIC to "price risk appropriately," and that underpriced deposit insurance premiums had a number of negative effects.[26]

The proposed legislation partially addresses this problem by setting reserve ratios for the new Mortgage Insurance Fund that appear to be floors, not caps, but I would go further and direct the Federal agency to establish a meaningful minimum nonzero charge for the fees charged to purely private parties for the Federal guarantee that applies even after the targeted reserve ratios have been met.

Conclusion

Because of the stability of the marketplace resulting from the conservatorships of Fannie and Freddie being overseen by the FHFA, Congress has the luxury of taking its time to get these issues right. In 1982, Congress first attempted to fix the problems of a broken housing finance system, and the struggling FSLIC, by expanding the powers of savings and loans. While accepted portfolio theory recognizes that diversification of investment classes can lower risk, the realities of the marketplace often steam roll theory. If those expanded powers had been limited by requiring them to be exercised only through acquisitions by existing commercial banks with experience in making those types of investments it might have worked. Instead, the law expanding savings and loan powers was exploited by a group of real estate developers who seized control of traditional savings and loans, operated under light touch supervision, and used them to fund their risky ventures. Congress back then certainly did not intend to invite rogue agents into the system, but flawed reliance on weak supervision created a perfect storm. The "cure" created by Congress in 1982 exacerbated the problem several fold, and the final cost to the Federal Government to make good on the insured deposits of failed savings and loans far exceeded the final cost to the Federal Government of the extraordinary measures taken under TARP.[27]

I am very concerned about the potential for a similar exacerbation of current problems. Certainly the existing problems that created insolvencies at Fannie and Freddie are significant and demand a permanent solution, but let the cure not be worse than the disease. Some type of Federal backing of the mortgage market appears to be a necessity if Congress desires American homeowners to have continued access to 30-year fixed-rate mortgages at an affordable cost.[28] But great care must be taken in designing a system where as yet unknown private parties will have access to a Federal guarantee. Whatever you design will be a huge magnet for those trying to exploit the system to make a quick profit and leave the taxpayers holding the bag.

[25] In 2006, the FDIC adopted a premium for 2007 in which banks had to pay at least 5 basis points. "FDIC Fees: A 5-BP Floor and Most To Pay More", Joe Adler, *American Banker* (Nov. 3, 2006), p.1.

[26] Prepared Testimony of FDIC Chairperson Tanoue, United States Senate Committee on Banking, Housing, and Urban Affairs, June 20, 2001. The FDIC Chairperson also noted that the FDIC's system was procyclical, exacerbating downturns, because "premiums are volatile and are likely to rise substantially during an economic downturn when financial institutions can least afford to pay higher premiums." Subsequent legislation and actions by the FDIC have reduced, but not eliminated, those distortions.

[27] Recent calculations indicate that net TARP outflows have been approximately $40 billion. *See, http://www.projects.propublica.org/bailout/*. In constant dollars, in 2009 the cost of the savings and loan crisis was estimated at $293 billion. *http://www.propublica.org/special/government-bailouts*

[28] The 30-year fixed-rate mortgage was first introduced by the FHA. "Private Risk, Public Risk: Public Policy, Market Development, and the Mortgage Crisis", Daniel Immergluck, 36 *Fordham Urb. L. J.* 447, 456 (April 2009). By 1970, FHA still accounted for 30 percent of single family loans. Id. at 457.

Exhibit A

Current Structure of Housing Finance System

Federal Housing Finance Agency

Examination Powers & Safety and Soundness Supervisor for Fannie, Freddie, the FHLBanks and FHLB Office of Finance

Fannie Mae

Owned by Public

Holds Assets in Portfolio

Purchases Mortgages from Public

Issues Securities to Public

Freddie Mac

Owned by Public

Holds Assets in Portfolio

Purchases Mortgages from Public

Issues Securities to Public

Federal Home Loan Banks

Owned by Members

Holds Assets in Portfolio

Makes Loans to Members

FHLB Office of Finance

Joint Office of FHLBanks

Issues FHLB debt securities to Public

Exhibit B

S. 1217 Proposed Structure of Housing Finance System

Federal Mortgage Insurance Corporation

Examination Powers & Safety and Soundness Supervisor of FHLBanks and Office of Finance

Sets Standards for Issuers and Others involved in Securitization of Guaranteed MBS

Guarantees MBS created by private parties through Mortgage Insurance Fund to extent loss exceeds first loss position of either private investor or private Bond Guarantor

Approved PMI Companies

Issues insurance on FMIC eligible mortgages where the Loan to Value Ratio exceeds 80 percent

Approved Issuers

Issues Covered Securities to Public with Guarantee from FMIC

Federal Home Loan Banks

Owned by Members

Holds Assets in Portfolio

Makes Loans to Members

Approved Mortgage Servicers

Services Eligible Mortgages underlying Covered Securities

Approved Bond Guarantors

Primary Guarantor on Cover Securities that stands in front of FMIC guarantee

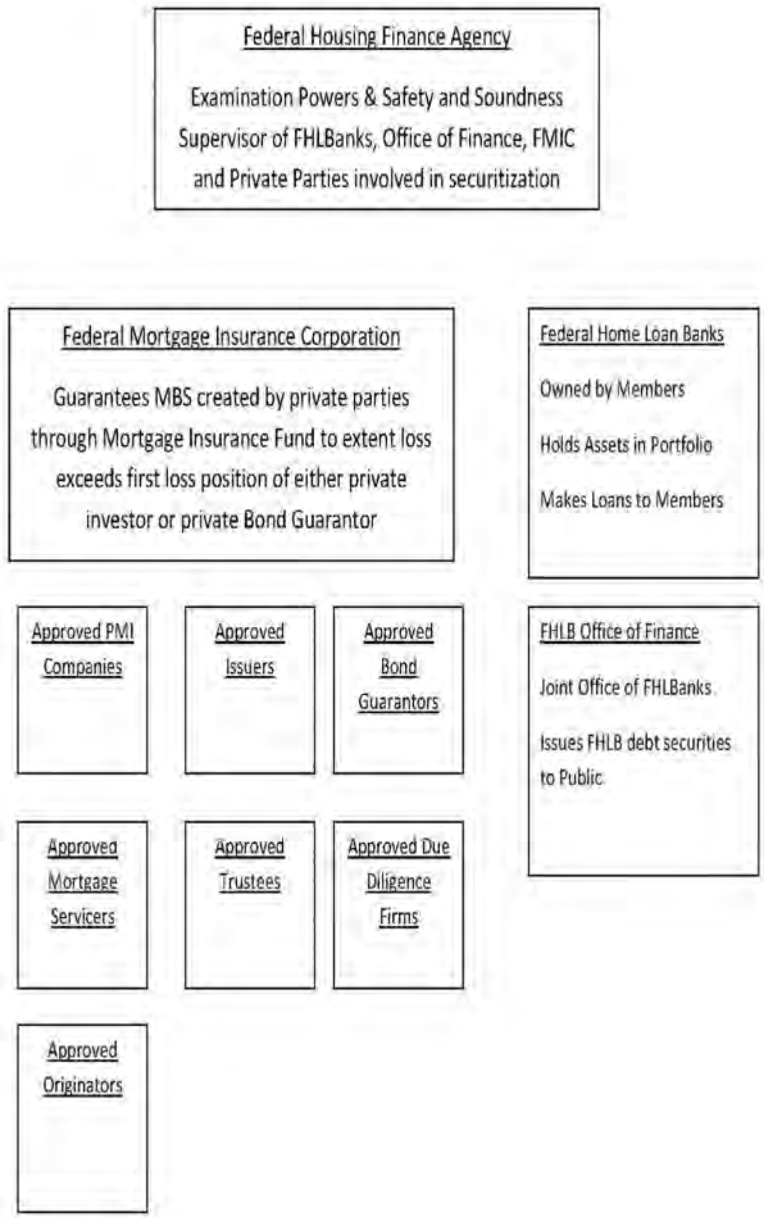
FHLB Office of Finance

Joint Office of FHLBanks

Issues FHLB debt securities to Public

Exhibit C

Alternative Structure of Housing Finance System



PREPARED STATEMENT OF ROBERT M. COUCH

COUNSEL, BRADLEY ARANT BOULT CUMMINGS, LLP, ON BEHALF OF THE BIPARTISAN POLICY CENTER HOUSING COMMISSION

NOVEMBER 21, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to be here today to discuss housing finance reform.

Before I get into the substance of my remarks, I want to commend the Committee for the deliberate, bipartisan approach it has taken in examining this very complicated subject, one of immense importance to the American people and our Nation's economy. The series of hearings that the Committee has convened have done an excellent job in illuminating the key decision points in designing a new, more sustainable housing finance system. These hearings, in turn, have performed a vital service by helping educate the public.

This past March, the Committee heard from my good friend and colleague Senator Mel Martinez, who outlined the housing finance reform recommendations of the Bipartisan Policy Center Housing Commission.

Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, the Bipartisan Policy Center is a Washington-based think tank that actively seeks bipartisan solutions to some of the most complex policy issues facing our country. The Housing Commission was launched in October 2011 with the financial support of the John D. and Catherine T. MacArthur Foundation. The commission has 21 members from both political parties who bring to the table a wide variety of professional experiences. Former Senators George Mitchell, Kit Bond, and Mel Martinez, and former HUD Secretary Henry Cisneros, serve as commission cochairs.

Suffice it to say that the commission strongly supports the objectives of S.1217, the Housing Finance Reform and Taxpayer Protection Act, and I am pleased that many of the bill's provisions reflect our own recommendations. Like S.1217, the commission proposes the wind down of Fannie Mae and Freddie Mac over a multiyear transition period; a greater role for private capital in assuming mortgage credit risk; and a continued Government presence through a limited "catastrophic" guarantee of mortgage-backed securities that is funded through the collection of actuarially sound fees charged to borrowers. The commission believes that a limited Government guarantee in the secondary market is essential to ensure widespread access to long-term and fixed-rate mortgage financing, in particular the 30-year fixed-rate amortizing single-family mortgage.

The Powers of the New Regulator

The new housing finance system envisioned by the commission and outlined in S.1217 will only work with a strong regulator at the system's center. This regulator will function as "Mission Control" for the new system and will be charged with fulfilling two responsibilities that are admittedly in tension: promoting a widely accessible mortgage market, while protecting the wallets of the American taxpayers.

The commission calls its proposed regulator the Public Guarantor, while S.1217 establishes the Federal Mortgage Insurance Corporation (FMIC) to assume the regulatory and guarantee functions currently performed by the Federal Housing Finance Agency (FHFA), Fannie Mae, and Freddie Mac.

Under the system envisioned by the commission and outlined in S.1217, the new regulator would have significant powers and responsibilities, including (a) guaranteeing investors the timely payment of principal and interest on covered mortgage-backed securities (MBS); (b) collecting fees in exchange for providing this insurance as well as to cover operational costs; (c) establishing and maintaining a catastrophic risk fund; (d) developing credit risk-sharing mechanisms for private entities to assume the first-loss position; (e) qualifying private institutions to serve as issuers of securities, servicers, private mortgage insurers, bond guarantors, and other types of credit enhancers; and (f) overseeing and supervising the common securitization platform developed by the FHFA.

S.1217 also commendably seeks to promote transparency and standardization in the market by directing the FMIC to maintain a database of uniform loan level information on eligible mortgages, establish an electronic registry for eligible mortgages that collateralize covered securities, and develop standardized securitization agreements. Greater transparency and standardization should encourage more risk-bearing private capital to enter the mortgage system.

As the former president of a savings bank in Alabama, I particularly appreciate the provisions of S.1217 that require the FMIC to facilitate access to the secondary market by small, midsize, and community banks, many of whom may lack securitization capabilities. Ensuring access to the Government-guaranteed secondary market on full and equal terms to lenders of all sizes and types was a major objective of the commission.

Looking at S.1217, let me highlight five areas where the Committee can strengthen the FMIC's role in the new housing finance system while promoting mortgage liquidity:

1. The Ginnie Mae Model. The commission examined a variety of models around which to design a new housing finance system. We concluded that the Ginnie Mae model offers a number of distinct advantages that can be successfully reproduced in the segment of the mortgage market now dominated by Fannie Mae and Freddie Mac. This model has a proven track record of promoting broad access to affordable mortgage credit while posing minimal risk to the taxpayers.

An important advantage of a Ginnie Mae-like approach is that it allows for a greater number of financial institutions to be issuers of MBS. As applied to the FMIC, the Ginnie Mae model would carefully align the interests of all the parties in the mortgage chain and allocate risk among them: (1) the borrowers (who have downpayment and home equity risk and, in some States, face the risk of a deficiency judgment); (2) the MBS issuers (who maintain the risk associated with "representations and warranties") and the mortgage servicers (who have risk for the timely payment of principal and interest); and (3) a credit-enhancement facility that assumes "first-loss" credit risk. Like Ginnie Mae, the Public Guarantor would stand in the fourth-loss position (behind borrowers, MBS issuers and mortgage servicers, and private credit enhancers) with a significant buffer of protection for the taxpayers. [1]

As you revisit S.1217, we urge you to consider legislative language that would allow the FMIC to replicate the Ginnie Mae model as a part of its ongoing operations.

2. Common Securitization Shelf. The commission felt strongly that the portion of any new housing finance system guaranteed by the Public Guarantor must have a single security or "common shelf" for single-family mortgages in order to ensure the system's liquidity, interact effectively with the To-Be-Announced (TBA) market, and establish an equal playing field for lenders of all sizes. A common shelf also allows mortgages with different terms, interest rates, and other attributes to be pooled into a single security.

In our proposal, the Public Guarantor is specifically directed to provide a common shelf. Based on our reading, it is unclear whether S.1217 contemplates the FMIC guaranteeing a single, common security or multiple securities. We recommend that the FMIC be explicitly directed to provide a common shelf for the segment of the market it backstops and to focus its efforts on promoting the liquidity of the new mortgage-backed securities.

3. Resolution Authority. Under the commission's proposal, the Public Guarantor would have the authority to temporarily take over the business of issuers, servicers, and/or private credit enhancers that happen to fail and to transfer that business to other private participants in the mortgage system. S.1217 does not appear to give the FMIC the same type of resolution authority. With resolution authority, the FMIC can help preserve liquidity and ensure a fully functioning market, particularly during periods of economic stress.

4. Emergency Authority. The commission also proposed that the Public Guarantor be given the authority to price and absorb first-loss credit risk for limited periods during times of severe economic stress in order to ensure the continued flow of mortgage credit. Under these circumstances, the Public Guarantor would be required to notify the Treasury Department, the Federal Reserve, and the chairs of the appropriate congressional committees before taking any such action.

S.1217 provides the FMIC with similar emergency authority, but this authority is subject to a number of more stringent conditions. First, the authority may only be exercised upon the written agreement of the Chairman of the Federal Reserve Board and the Treasury Secretary, in consultation with the HUD Secretary. Second, it may only be exercised for a period of 6 months. Third, the authority may not be exercised more than once in any given 3-year period. [2] While these safeguards are understandable, the Committee may wish to consider empowering the FMIC with the flexibility to respond more quickly to emergency conditions in the mortgage market.

5. Wind Down of Fannie Mae and Freddie Mac. The hard and fast 5-year deadline that S.1217 proposes for transitioning from the current Government-dominated housing finance system to one in which private capital plays a larger role in bearing

[1] Ginnie Mae in its current form might not have sufficient capacity to become the Public Guarantor, but might be a suitable vehicle if given greater authorities and flexibilities.

[2] Section 205.

credit risk may not allow for sufficient flexibility and adjustments during this critical period. The commission adopts a more flexible approach by suggesting that a transition period of 5 to 10 years be built into the legislation.

Structure and Governance of the New Regulator

The FMIC and the Public Guarantor are similar in that both would be self-supporting institutions that do not rely on Federal appropriations but rather finance their catastrophic risk funds and operational expenses through the collection of guarantee fees. The primary purpose here is to protect the taxpayers from unnecessary risk, but operating largely outside the appropriations process also gives the institutions some insulation from political interference.

S.1217 describes the FMIC as an "independent agency of the Federal Government,"[3] whereas the commission proposes that the Public Guarantor be established as an independent, "wholly-owned" Government corporation under the Government Corporation Control Act of 1945.[4] The commission concluded that establishing the Public Guarantor as a wholly-owned Government corporation would provide it with an additional layer of protection from political influence while subjecting it to well-established budgetary and fiscal controls.[5] We encourage you to examine whether this type of organizational structure is appropriate for the FMIC.

S.1217 appropriately specifies that the multifamily businesses of Fannie Mae and Freddie Mac must be transferred to the FMIC, and it appears that the Mortgage Insurance Fund would cover both single-family and multifamily mortgage-backed securities.[6] The commission, on the other hand, concluded it was best to establish separate single-family and multifamily catastrophic risk funds since single-family and multifamily lending are fundamentally different businesses with different underwriting approaches. I encourage the Committee to take a second look at this issue.

Governance

With respect to the governance of the new regulator, the commission ultimately recommended vesting authority in a single individual appointed by the President of the United States and subject to Senate confirmation. In reaching this judgment, we recognized that the regulator of the new system would have an enormous set of responsibilities, particularly in the early stages of the new system's build out. Our view was that putting a single person in charge would promote accountability and ease of decision making.

Ginnie Mae does not operate under a Board of Directors with management oversight responsibilities.[7] In my view, and speaking as a former President of the organization, Ginnie Mae has consistently been one of the best-run organizations within the Federal Government. But I certainly understand that its governance model is somewhat unique among Federal agencies and there are logical reasons for establishing a Board of Directors for the FMIC.

The most compelling reason is that rebooting our Nation's housing finance system and running the FMIC is a huge undertaking requiring a deep bench of experience. An engaged, experienced Board of Directors can be an enormously valuable asset to the Director of the FMIC. While the Director should have demonstrated experience in financial management and a broad understanding of the capital markets, he or she must also be someone who can draw upon and utilize the skills of others, including the members of the FMIC Board, and inspire the members of the FMIC

[3] Section 101(c).

[4] Examples of wholly-owned Government corporations include Ginnie Mae, the Export-Import Bank of the United States, the Overseas Private Investment Corporation, and the Pension Benefit Guaranty Corporation.

[5] While there is no general incorporation statute at the Federal level, the Government Corporation Control Act of 1945, as amended (GCCA), does provide for standardized budget, auditing, debt management, and depository practices for most Government corporations. Under the GCCA, "wholly-owned" Government corporations are required to submit annual "business type" budgets to the President. *See,* Kevin R. Kosar, "Federal Government Corporations: An Overview", Congressional Research Service (June 8, 2011). Among a number of items, these budgets must (a) contain estimates of the financial condition and operations of the corporation for the current and following fiscal year, (b) contain estimates of operations by major activities, administrative expenses, borrowings, and any appropriations that may be needed to restore capital impairments, and (c) provide for emergencies and contingencies. Budgets submitted to the President by the Government corporation become part of the budgets submitted by the President to Congress.

[6] *See,* Section 203.

[7] The President of Ginnie Mae is responsible to the Secretary of HUD and, ultimately, to the President of the United States.

staff to work at a high level of proficiency. Having these personal qualities is essential for the FMIC Director to be effective.

If, as contemplated by S.1217, the FMIC is to be managed by a Board of Directors, I encourage the Committee to amend the legislation to ensure that members of both political parties are represented on the Board. Bipartisan representation on the FMIC Board will provide some assurance to the public and Congress that the Board is making decisions for sound operational and risk-management reasons, and not because of political considerations. Building public confidence in the new housing finance system will be particularly critical in the early stages of its development.

There is plenty of precedent for this bipartisan approach: Critical financial regulatory agencies like the Securities Exchange Commission and the Commodities Futures Trading Commission are required to have political balance. Likewise, no more than three members of the five-member Board of Directors of the Federal Deposit Insurance Corporation may have the same political affiliation. While there have been occasions when these and other similarly governed Boards and commissions have descended into partisan bickering, the totality of the evidence over the years suggests they have worked reasonably well.

I strongly support S.1217's requirement that members of the FMIC Board have significant experience in at least one of the following fields: asset management, mortgage insurance, community banking, and multifamily housing. [8] This requirement will help ensure that relevant experience is represented on the Board. There is also precedent for this approach. For example, one of the members of the FDIC Board is required by statute to possess a background in State bank supervision.

During my career in the mortgage banking industry, I have seen first-hand how duplicative and overlapping examination and reporting requirements can increase expenses and raise mortgage costs. To improve coordination among our Nation's financial regulators, as well as to facilitate information sharing about market developments and potential risks to the stability of the financial system, I support S.1217's decision to make the Chairperson of the FMIC a member of the Financial Stability Oversight Board (FSOC). [9] As we build a new housing finance system, FSOC should promote regulatory streamlining and harmonization and, when appropriate, encourage regulators to rely on the work and conclusions of their counterparts to avoid unnecessary duplication.

Finally, I support the establishment of an Office of Inspector General (IG) within the FMIC to promote the efficient operations of its programs and detect and deter fraud and other forms of corruption. [10] I also support the additional requirement established in S.1217 that the FMIC IG conduct periodic audits of the adequacy of the private capital assuming the first-loss position in the new housing finance system and make recommendations for addressing any deficiencies. [11] By requiring the IG, as well as an independent actuary, to issue annual reports to Congress on the adequacy of the guarantee fees charged by the FMIC and the Mortgage Insurance Fund itself, S.1217 provides an important mechanism to assist Congress in performing its oversight responsibilities. [12]

Thank you for your attention. I look forward to your questions.

PREPARED STATEMENT OF PAUL LEONARD

SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS, THE HOUSING POLICY COUNCIL OF THE FINANCIAL SERVICES ROUNDTABLE

NOVEMBER 21, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear before you today.

My name is Paul Leonard and I am the Senior Vice President of Government Affairs of the Housing Policy Council of the Financial Services Roundtable. The 31 members of the Housing Policy Council originate, service, securitize, trade, invest in, and insure mortgages. We estimate that our member companies originate three quarters of all residential mortgages in the U.S. and service about two-thirds of those mortgages.

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[8] Section 103(a)(1)(B)(i) through (iv).

[9] Section 102(c).

[10] Section 104.

[11] Section 104(a)(2)(A)(i).

[12] Section 104 (a)(3)(A) and (B). S.1217 also requires the Comptroller General of the United States to conduct an annual audit of the financial transactions of the FMIC. These audits, too, should assist Congress in performing its oversight responsibilities. Section 106(c).

The Housing Policy Council strongly supports reform of our Nation's housing finance system. Our members appreciate the time and attention Chairman Johnson, Ranking Member Crapo, and the Committee are devoting to housing finance reform. We also want to thank Senators Corker and Warner and their cosponsors for their thoughtful and significant contribution to advancing housing finance reform.

For many years, consumers, lenders, the housing industry, and the broader economy benefited from the secondary mortgage market that was facilitated by Fannie Mae and Freddie Mac, the housing GSEs. At the height of the financial crisis, however, fundamental flaws in the design and operation of the GSEs were exposed. Those flaws included insufficient capital requirements and an inherent tension between the interests of private shareholders and the public mission of the GSEs. The GSEs also were subject to a certain amount of "moral hazard" since they operated under a special congressional charter that shielded them from traditional market forces.

A new model is needed for the secondary market in conventional mortgage loans that preserves the availability of stable mortgage credit for qualified homebuyers, retains key operations, systems, and people critical to the current system, and corrects the flaws in the existing GSE model by requiring more private capital and better protection for taxpayers.

The structure and duties of the Federal agency charged with overseeing the successors to the GSEs is equally important. Just as the structure of the GSEs contributed to the crisis, so too, did the structure and the limits on some of the powers of the Office of Federal Housing Enterprise Oversight (OFHEO).

Congress corrected many of those problems with the passage of the Housing and Economic Recovery Act of 2008 (HERA). Unfortunately, those reforms came just as the financial crisis was cresting and could not prevent the collapse of the GSEs. Given that history, the members of the Housing Policy Council support a strong and effective regulatory structure for the entities that will replace the GSEs.

In the balance of my statement, I will highlight what we believe are the more important features of that structure, how those features compare to some of the provisions in the Corker-Warner bill, and how they mesh with our vision of housing finance reform.

The Structure of the Federal Regulator

First, as Senators Corker and Warner have proposed, we support the creation of an independent Federal agency to oversee the transition from the current GSE system to a new structure for housing finance. We also agree that the independence of this agency is enhanced by a funding structure that is based upon assessments and fees as opposed to Congressional appropriations. While we appreciate the checks and balance that are provided by the appropriations process, insufficient funding of OFHEO inhibited that agency's ability to properly supervise the GSEs.

Like the Corker-Warner bill, we support the creation of a board to govern the agency, the members of which would be appointed for staggered multiyear terms. Multiyear terms remove the members of the board from the shifting winds of politics. And a board, rather than a single director, ensures a greater continuity of policies and sufficient consideration of alternative perspectives. Care needs to be taken, however, not to micromanage the qualifications for membership on the board. The goal should be to ensure that board members have sufficient experience and judgment to oversee the agency.

The Corker-Warner bill proposes different divisions to handle key duties of the agency. It calls for a division on underwriting, a securitization division, and a division to oversee the Federal Home Loan Banks. Creating separate divisions to focus on the unique issues within each of these areas is appropriate.

The Corker-Warner bill also proposes the establishment of advisory committees. We support the creation of advisory committees to help ensure regular contact with stakeholders to enhance the knowledge base of the agency and the quality of its activities. Indeed, we would recommend that the creation of advisory committees be mandated, since discretionary authorities can be ignored. FSOC provides an example of such a neglected authority.

We agree with the requirement in the Corker-Warner bill that the new regulatory agency have its own Inspector General. It is appropriate to provide for this oversight and prevent fraud and abuse. At the same time, care needs to be taken not to have the Inspector General become a "shadow" regulator by giving the Inspector General authority to review and second guess policy decisions of the board. The additional powers the Corker-Warner bill gives the Inspector General may tilt in that direction.

The Duties of the Federal Regulator

Let me now turn to the duties of this agency. We believe that the fundamental duty of the agency should be to ensure that the secondary mortgage market operates in a safe and sound manner. In other words, the new agency should be, at its core, a prudential regulator that ensures the integrity of the market and the solvency of the reserve fund that stands before a Federal guarantee. If the agency performs this basic duty properly consumers, and the economy as whole, should enjoy a steady flow of reasonably priced conventional mortgage credit in all economic cycles.

As a prudential regulator, the agency should have the authority to set standards for the segment of the secondary market that is linked to a Federal guarantee. That should include setting the boundaries of the acceptable credit terms associated with federally guaranteed mortgage securities. These boundaries, alone, should prevent the types of problems experienced by the GSEs. Also, to enhance the liquidity of federally guaranteed mortgage securities, the agency should establish the terms and conditions governing pooling and servicing agreements and should establish common terms and conditions for guaranteed mortgage securities. In other words, the agency should provide for the creation of a single form of guaranteed security that promotes a simple, liquid and transparent market. On the other hand, the agency should not have authority to set standards for the private label market. That market will not be supported by any form of Federal guarantee and should be able to evolve independently. Indeed, effective operations in that market can serve as a signal on the health of the overall market to the new agency.

In exercising its standard setting authority, the agency should be required to seek public comment. While we give FHFA high marks for the manner in which the conservatorship has been conducted, many of the policy actions taken under the conservatorship have fallen outside the scope of the normal notice and comment process. Going forward, the basic standards and policy actions taken by the new agency should be subject to public notice and comment. This process will give all market participants and the public the opportunity to comment on proposals and decisions by the regulator and will increase confidence in the process and the decisions made by the regulator.

This Federal regulatory agency also should have the power to federally charter, or otherwise certify, the key participants in the market for guarantee securities. In other words, the Congressional charters granted to the GSEs should be repealed and the entities that take their place should be subject to a chartering process similar to the chartering of a national bank or a Federal thrift. This new regulatory chartering process will also eliminate the perception of the special status that the GSEs experienced through their unique charters.

The agency should have examination and enforcement powers, including resolution powers. Congress did give such authorities to FHFA in HERA, and those authorities should be extended to the new agency. Congress should also require the agency to have a concrete resolution plan for the successors to the GSEs so that all market participants can understand how they would be resolved, if necessary.

The agency should have rulemaking powers, including the power to set appropriate capital standards and the power to adjust conforming loan limits. Congress should resist hardcoding some standards, including capital standards, in law. Setting appropriate capital standards requires a complex analysis and detailed consideration of market conditions, as well as consumer impact. Moreover, setting specific standards into the statute could have unintended consequences in different economic cycles. Congress has long deferred to the expertise of the Federal banking agencies to set the specific capital standards for banking firms. We believe that a similar approach should be applied to the firms that replace the GSEs. This discretionary authority also would permit the agency to adjust capital in periods of severe economic downturns to ensure that the market continues to function.

Likewise, Congress should give the new agency some flexibility to determine the point at which the Federal guarantee on qualifying mortgage securities is triggered. This trigger point may differ for different structures. In other words, the trigger point for securities backed by a federally chartered guarantor may not be the same as the trigger point for a securities structure in which investors assume some first loss risk on those securities. However, whatever the triggering point is should be clearly disclosed to investors, and it should be clearly understood that the Government guarantee stands behind private capital and a reserve fund that is funded by industry.

In those cases in which the agency is given some flexibility to set prudential standards, the agency should be required to explain its rationale for the standards and justify them. This could be achieved through regular reports to Congress.

The agency should have responsibility for the reserve fund that stands in front of the Federal guarantee. This should include setting the price for the guarantee and the premiums to be paid into the reserve fund to ensure that private capital stands before the taxpayers. We strongly disagree with the assertion by some that such a fee structure cannot be priced to protect taxpayers. The FDIC's bank insurance fund serves as an example of a Federal guarantee program that has never imposed a cost on taxpayers.

The agency should be authorized to oversee the establishment of a securitization platform for federally guaranteed securities. This platform should be used as the basis to securitize and manage a single agency security created by multiple participants. Such a platform would likely influence the private label market, but the issuers of private label securities should not be required to use the platform. While some issuers may choose to do so, it would be preferable to have separate and distinct platforms to maintain a clear distinction between guaranteed and nonguaranteed securities.

Finally, the agency should not be burdened with too many responsibilities that would detract from its basic prudential mandate. For example, we do not see the need for the agency to oversee a Mutual Securitization Corporation for smaller firms as long as a cash window is available for such firms The cash windows operated by the GSEs have provided smaller firms with full access to the secondary market, and the GSEs should continue to provide this function during the transition period. We would not, however, oppose the creation of a Mutual Securitization Corporation or similar facility it is deemed necessary.

More importantly, the agency should not have antitrust and market pricing powers, as implied by section 216 of the Corker-Warner bill. Other agencies already have sufficient antitrust powers, and pricing controls would only have a market distorting impact. Nor do we believe that the agency should be responsible for overseeing an electronic mortgage registry, as proposed in the Corker-Warner bill. This may be needed, but this authority would detract from what should be the prudential mandate of the new agency.

Our Vision of Reform

The model for the secondary market that we favor is a guarantor structure built around several privately capitalized companies that would be chartered and regulated by the new agency. Under this model, lenders of all sizes and business models would originate mortgage loans that meet certain minimum standards and sell those loans to the guarantors in exchange for mortgage securities or cash. The federally chartered guarantor then would assume the credit risk on the securities.

The Corker-Warner bill also envisions a capital markets structure, in which any entity could issue Government guaranteed mortgage securities provided the entity met appropriate standards, including the assumption of a first loss position. We have no objection to the inclusion of such an option in the legislation. However, we believe that there are significant impediments to its effective implementation, not the least of which is the ability for investors to assess the credit risk of the securities.

The Corker-Warner bill also provides that guarantors and issuers could be separate entities. Again, we have no objection to this option, but would note that separate entities would require separate capital structures and there are limits on the amount of private capital to support housing finance. Moreover, there are market efficiencies associated with the combination of the guarantor and issuance functions. Such a structure provides a single point of contact for lenders in the securitization process. Additionally, to the extent that the separation of these functions is based upon concerns related to market concentration, we would note that current accounting and capital rules would prevent an originator from controlling a guarantor since it is unlikely that the originator could gain "true sale" treatment for the mortgages it acquirers.

The securities issued under this model should carry an explicit "backstop" Federal guarantee that ensures payments to investors in the event a guarantor could not perform on its guarantee. Guarantors would pay a fee for the Federal guarantee and part of that fee would be placed into a reserve fund, administered by the Federal agency. Guarantors also should be able to transfer the credit risk that they assume to other parties through reinsurance and capital markets structures. Additionally, as I previously noted, guarantors should maintain a "cash window" to purchase and to aggregate whole loans for smaller lenders. On the other hand, guarantors should not be permitted to engage in loan origination, mortgage servicing or speculate in mortgages or mortgage backed securities.

The securities created by guarantors would be run through a shared securitization platform. This shared platform would provide common administrative and systems support for the guarantors and would ensure that the securities have a single form with common terms and conditions.

While this model has some similarities to the existing GSE model, it differs in several key respects:

- *Market Distortions Created by "Implicit" Federal Support for the GSEs Eliminated*—Guarantors would not be granted any of the special privileges currently given to the GSEs under their Congressional charters (e.g., exemption from State taxation, line of credit with Treasury). The guarantors would be chartered by the Federal agency, and the "explicit" Federal guarantee provided under this model would apply only to the securities, not to any other debt or equity of the guarantors;
- *Systemic Risks Reduced Through More Limited Role in Securitization Process*—The role of the guarantors would be limited to credit enhancement and securities issuance. Other key processes associated with securitization would be performed by a shared securitization platform. This limitation on the functions of the guarantors reduces systemic risks and reduces barriers to entry.
- *Systemic Risks Reduced Through Limitations on Activities*—Unlike the GSEs, guarantors could not establish portfolios to speculate in mortgages or mortgage securities;
- *Tensions Between Competing Missions Eliminated*—Guarantors would not be subject to specific housing goals, thereby avoiding the conflict that existed between the shareholders of the GSEs and the public mission of the GSEs;
- *Competition Enhanced Through Multiple Guarantors*—This model envisions more than just two guarantors. The mandatory use of a common securitization platform would reduce barriers to entry for entities seeking to act as guarantors since it would reduce the costs associated with designing and implementing key administrative functions associated with securitization. The new Federal agency also should be encouraged to promote the development of multiple guarantors.
- *Prudential Regulation and Supervision Enhanced*—Guarantors would be subject to more stringent regulation and supervision than the GSEs, including heightened capital standards set by the new agency.

Some Transitional Steps

The transition to any new model for the secondary market will take some time. We commend FHFA for the key steps that it has taken in that process, including new risk sharing arrangements, adjustments to guarantee fees and proposed adjustments to conforming loan limits. We commend FHFA for the steps it has taken, and suggest the following additional actions during the transition to a new system:

- *Single Security*—FHFA could increase the liquidity in the current agency market and reduce taxpayer costs by creating a unified agency security that can be substituted for Fannie Mae MBS and Freddie Mac PCs (the terms and conditions applicable to this new security would then serve as a foundation for the standard securitization agreements applicable to guaranteed securities issued under our proposed new system);
- *Reps and Warranties*—FHFA has made some progress toward reforming representations and warranties applicable to mortgages sold to the GSEs. However, the rep and warranty framework continues to inhibit new loan generation, and requires additional reforms;
- *Risk-Sharing Structures*—FHFA should continue to develop risk-sharing arrangements with GSE securities to increase the level of private sector capital in front of the Federal Government. These structures could then be adopted by guarantors following the transition from the GSEs to the new model;
- *Data Disclosure*—FHFA has facilitated some greater data disclosure, but additional data on credit performance and loan loss severity is needed to attract investors to new risk sharing arrangements;
- *Guarantee Fees*—FHFA's efforts to induce or "crowd" private capital back to the market by increasing guarantee fees are not the only steps needed to entice additional private capital into the market. The obstacle to a more vibrant private market is not only price, but a more efficient securitization process. Additional increases in guarantee fees may only increase costs for consumers and profits for the GSEs; and
- *Conforming Loan Limits*—Gradually reducing the existing conforming loan limits and aligning the limits applicable to the GSEs and FHA. The reduction in the loan limits should be done with careful consideration of current market conditions.

Conclusion

The Housing Policy Council supports reform of the secondary mortgage market system. These reforms should create a system that can provide consistent availability of stable products like the 30-year fixed-rate mortgage to American consumers by requiring more private capital and stronger protections for the taxpayer. A reformed system should include a Government backstop behind layers of private capital and a strong prudential regulator to set standards and oversee the participants in a new secondary mortgage market system.

We look forward to working with the Committee in its efforts to produce bipartisan housing finance reform legislation. Thank you.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM ALFRED M. POLLARD

Q.1. On what date will the entire Common Securitization Platform be ready to perform all of its functions?

A.1. The Enterprises are currently developing the Common Securitization Platform (CSP), and have built the core functionality and the related infrastructure components. Preliminary testing is underway. The CSP's design and its development have necessarily evolved over time, and a significant amount of work remains with regard to both the CSP itself and the business entity that will own it. The Enterprises are engaged in developing and implementing operational and business processes for the CSP and the joint venture entity, and they are developing their integration plans critical to the success of the CSP. Fannie Mae and Freddie Mac are conducting this work under FHFA's guidance and with industry input. Consequently, plans for this project will continue to evolve as the Enterprises take into account the many factors that will drive project success. The project plans will not be finalized until the Enterprises, under FHFA's oversight, are in a position to do so. As a result, we do not yet have a date by which the Common Securitization Platform will be operational.

Q.2. When the Common Securitization Platform is finally ready to perform all of its functions, how much money, all in, will have been spent in total by FHFA, each GSE, and Common Securitization Solutions, LLC, including contracting costs? Does this cost include the cost of any adjustments and upgrades that may be necessary so that Fannie and Freddie can take advantage of the Common Securitization Platform? If not, what is this additional cost expected to be?

A.2. As discussed above, the Common Securitization Platform project plans, inclusive of the design, build and testing of the technology and the Enterprises' system and process changes, are being finalized. As a result, we have neither final plans nor specific budgets assigned to these still-in-development projects. To date, the following funds have been spent:

- CSP and CSS: $65 million (1/21/2012–12/31/2013)
- Fannie Mae Integration: $20 million (1/1/2013–12/31/2013)
- Freddie Mac Integration: $7 million (1/1/2013–12/31/2013)

Q.3. FHFA staff has stated that FHFA "has not prepared a formal valuation analysis regarding the platform," which I find disturbing, especially since taxpayer funds are essentially at stake here and are in the process of being spent. Should we be worried by the fact that FHFA is making financial decisions with taxpayer funds without any "formal valuation analysis regarding the platform?"

A.3. FHFA understands your concern but believes that the approach to the project has been prudent and well considered. The project is consistent and aligned with many other projects undertaken by the Enterprises, at the direction of the agency, to achieve uniformity in areas essential to achieving an effective mortgage securitization system. The Servicer Alignment Initiative, Common Appraisal Data Portal, and Uniform Mortgage Data Program are some of the projects that have established common and uniform standards and practices in the Nation's housing finance system, providing benefits not just to the Enterprises, but also to other market participants.

The decision to engage the Enterprises in this project is neither solely nor even principally a financial decision, although the financial costs associated with it are very important and being monitored. Rather, the decision is rooted in FHFA's legal obligations, both as conservator and regulator. The decision is based on achieving market efficiencies and providing policy makers with options as they determine the future of the U.S. housing finance system. The agency has determined that the building and operation of the CSP would also achieve many supervisory goals and realize other significant benefits.

Q.4. Fannie and Freddie are still two distinct legal entities, and FHFA acts as conservator for each GSE. Given how valuable the Common Securitization Platform would be to each GSE on its own, how did FHFA, as conservator for each GSE, determine that a 50/50 joint venture was the right decision for each GSE? In preserving and conserving the assets of Fannie with a view towards putting it in a sound and solvent condition, why would FHFA, as conservator for Fannie, give Freddie a 50-percent stake in such a valuable asset?

A.4. As Conservator, FHFA decided that it was most beneficial to establish common securitization technology, which would be available to Fannie Mae and Freddie Mac and ultimately to all market participants, rather than have each Enterprise separately undertake extensive and proprietary infrastructure projects. FHFA believes that building the CSP functionality once, through the joint and collaborative efforts of, and its use by, both Enterprises, will be more cost-effective than having each Enterprise independently rebuild its core securitization and servicing systems. Neither of the Enterprises' existing systems would allow for relatively quick, effective and efficient access by the industry either in the near or medium term. Furthermore, independent and proprietary Enterprise systems would not allow for uniformity across the mortgage finance industry, thereby exacerbating the current disarray within the industry and complicating the already difficult task before policy makers. FHFA believes that two different systems rather than common technology could seriously delay or complicate attempts to reform the Nation's housing finance system. Independent technology provides policymakers with greater options for reforming the system than would a rebuilding of the Enterprises' individual systems. FHFA and the Enterprises have established a process to ensure that each Enterprise's contribution to the joint venture is equitable and fair retroactively and prospectively.

Q.5. Please provide all formation documents prepared in conjunction with the formation of Common Securitization Solutions, LLC (CSS), including but not limited to the operating agreement, all legal opinions, all resolutions from the Board of Directors for each of Fannie Mae and Freddie Mac duly authorizing the formation of CSS, and documentation of all costs incurred thus far and expected costs associated with CSS.

A.5. We would be happy to provide you and your staff an opportunity to review the documents noted above at the FHFA offices. Please contact Peter Brereton, Associate Director for Congressional Affairs, if you would like to schedule such a review, and if you require additional information or have additional questions.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM DIANE ELLIS

Q.1. S.1217 proposes the regulator have, with the consent of other officials, emergency powers in a crisis that only lasts 6 months. Should we consider expanding that authority, or providing other countercyclical tools that a regulator may need in a future crisis?

A.1. Since the length, depth, and frequency of financial crises are hard to predict, any emergency systemic risk authority should allow some flexibility in the frequency or duration of the use of that authority.

The FDIC has found it important to have sufficient authority and flexibility to respond to crises promptly in a way that maintains public confidence and financial stability. The FDIC has always been funded by the banking industry. Under section 7 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. §1817, the FDIC has the specific authority to raise assessment rates and charge special assessments and broad authority to require prepayment of assessments. The FDIC has used this authority to cover losses and maintain liquidity during periods marked by a high volume of bank failures. The FDIC also has lines of credit with the U.S. Treasury and the Treasury's Federal Financing Bank, and can borrow from the banking industry and from the Federal Home Loan Banks.

The FDIC's ability to access these lines of credit coupled with the U.S. Government's full faith and credit backing of the FDIC's deposit insurance system reassures the public that the FDIC can pay its depositors promptly in the event of a bank failure, eliminating the risk of bank runs and panic. The lines of credit also reduce the likelihood of having to charge highly procyclical assessments. Ultimately, though, the banking industry would bear the costs of deposit insurance by repaying any emergency lines of credit were they to be drawn upon.

Q.2. What is needed in legislation to ensure that Federal and State regulators coordinate on supervision and resolution?

A.2. The FDIC has found its supervisory and resolution authorities essential to fulfilling its mission of protecting depositors and maintaining financial stability. The FDIC coordinates with Federal and State regulators under authorities provided by the FDI Act. These authorities include coordination and information sharing with other agencies, the ability to review examination findings for banks we do not supervise directly, and the ability to conduct backup examinations and reviews of those institutions as necessary.

The FDIC's most important tools in regulating entities primarily supervised by another agency are: (1) ongoing communications with the primary Federal regulators and State supervisors, (2) maintaining clear standards for sharing information and examination reports, (3) coordinating examination schedules, and (4) working together on interagency issues through the Federal Financial Institutions Examination Council. The FDIC has maintained a Memorandum of Understanding (MOU) with the other primary Federal regulators (Office of the Comptroller of the Currency [OCC], Board of Governors of the Federal Reserve System [FRB], and the former Office of Thrift Supervision [OTS]) on Special Examinations for many years, the most recent version updated in 2010. In addition, the FDIC, FRB, OCC, and National Credit Union Administration entered into a MOU with the Consumer Financial Protection Bureau in May 2012 to implement supervisory coordination and information-sharing requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

With respect to the proposed legislation, it is possible that many guarantors would already be subject to a regime of Federal or State regulation and supervision, which also may include a process to handle insolvency. This underscores the need for clearly defined roles and rules for cooperation and coordination between the FMIC and the various Federal and State regulators with authority over the guarantors. Where entities subject to the legislation are subject to oversight by other Federal or State agencies, the legislation could clarify requirements for coordination of examination activities and information sharing agreements.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM DIANE ELLIS

Q.1. Fannie Mae and Freddie Mac's duty to serve the entire primary market is an important aspect of our current housing finance policy. The duty to serve ensures that creditworthy people in all parts of the country can get access to mortgages with reasonable rates and terms. Without a duty to serve, people in rural areas, lower-income neighborhoods, and primarily immigrant or minority neighborhoods might find that mortgages are no longer readily available.

S.1217 envisions a secondary market with many issuers of Government-guaranteed securities. Unlike Fannie and Freddie, which serve the entire Nation, certain issuers in the S.1217 model may purchase loans only from certain parts of the country or may specialize in targeted loan profiles. Assuming there is a secondary market with several issuers, do you have views on how we could structure and enforce a duty to serve?

A.1. While a "duty to serve" for individual issuers could be created by establishing and enforcing obligations similar to those in the Community Reinvestment Act, bringing affordable rate mortgages to some communities that would otherwise not be served by the marketplace, eliminating the nationwide scope of the territory Fannie and Freddie occupy with respect to their issuance of securities almost certainly means that many hundreds of communities in this country would see a drastic increase in mortgage rates, and a significant decrease in the availability of mortgage credit. I do not believe that there is any other mechanism for addressing this issue other than having an issuer with a nationwide scope.

Q.2. It's critically important that regulators of the housing finance market have the authority to take countercyclical action—to slow things down when the market is heating up too rapidly, and to open the flow of credit when the market slumps too low. As we've seen, the housing market is naturally procyclical, and regulators must be able to temper those boom-bust cycles to ensure availability of credit and to protect taxpayers.

One way to exert countercyclical pressure is to raise Government guarantee fees during boom periods and lower the fees during declines in the market. But that won't work unless regulators have the authority to exert countercyclical pressure on the private-label market as well—otherwise, when guarantee fees go up during a boom period, it will just drive securitization from the guaranteed market to the private label market.

Do you have any ideas on how regulators can exert countercyclical pressure on the private-label market?

A.2. Neither a regulatory agency nor a Government credit facility has particularly powerful tools to dampen a boom that occurs during bouts of irrational exuberance.

A Government credit facility, such as a Federal Home Loan Bank, can expand its balance sheet and provide needed credit during a bust; but during a boom, private sources of funding will displace it.

If you grant a regulatory agency the power to set safety and soundness standards in the private-label market that must be met before any issuer can sell securities to the public, the regulatory agency could exert some countercyclical pressure on the market through enforcing those standards. The most important thing a regulatory agency could do during a boom period is to avoid relaxing its standards, and continue rigorous enforcement of existing standards in the private-label market. For example, when the OTS relaxed its standards on what constituted a safe lending program, and allowed savings and loans to offer riskier loan products with teaser rates and negative amortization during the boom period in the last decade it added further fuel to the bonfire. Theoretically, a regulatory agency could increase the safety and soundness standards applicable to private market participants during a boom period. If the threshold for a safe mortgage loan is a twenty (20) percent downpayment during ordinary times, a regulatory agency could increase the standard to twenty-five (25) percent during a boom time to protect against the potential for a larger fall in prices. That is somewhat similar to what certain exchanges do to margin requirements for particular securities or commodities that have a sudden and significant increase in price. However, in the nearly 30 years in which I have practiced law in the housing finance sector, I have not witnessed any regulator of housing lenders make a meaningful increase in safety and soundness standards during the boom times; it is only after the losses accrue that regulators take note and increase safety standards.

In addition to maintaining rigorous enforcement of safety and soundness standards, imposing requirements for transparency and accountability is also important. Having meaningful claw back provisions on compensation of senior management of private lenders ensures that managers who profit during the boom times, and then depart, are held accountable for their actions. If such managers know that claw backs with real teeth are in place, they will have an incentive to act with more prudence during the boom times because they will be accountable during the bust. Transparency, and full disclosure of all material lending criteria to investors, is important so that participants can judge whether other parties are acting prudently, and steer their own business away from those who act imprudently during a boom time. Warren Buffet famously has said it is only when the tide goes out during the bad times that we can see who is wearing a bathing suit; if the water were less murky during the good times we could see who is wearing a bathing suit before the tide went out. In my view, the most important thing Congress can do is acknowledge that housing is a very procyclical industry, and build in significant safeguards that will lessen the damage when the inevitable bust occurs.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KIRK FROM DIANE ELLIS

Q.1. The FDIC's mandate is made very clear as you note in your written testimony—"to protect depositors and maintain financial stability." The new FMIC will have both a supervisory role and a role to oversee the insurance fund. What do you think the mandate of the FMIC should be?

A.1. Congress has given the FDIC a clear mandate: protect depositors and maintain financial stability. Congress has explicitly defined the amount of deposits covered under the FDIC deposit guarantee, and when insurance coverage is triggered (that is, when a bank fails). Clarity is important not just because it enables the FDIC to do its job, but because it establishes credibility in the eyes of depositors. The FDIC's explicit statutory authority assists in accomplishing our mission, and we rely on this authority along with supervisory tools to identify risk and take action to mitigate such risk.

The bill the Committee is considering clearly states two purposes of the FMIC: (1) to provide liquidity, transparency, and access to mortgage credit by supporting a robust secondary mortgage market and the production of residential mortgage-backed securities, and (2) to protect the taxpayer from having to absorb losses incurred in the secondary mortgage market during periods of economic stress. How to best balance these policy priorities is a question properly reserved for Congress.

Q.2. Do you think that the FMIC will need two separate divisions—one for supervision and one for the insurance fund?

A.2. Congress has consistently provided the FDIC with clear and explicit statutory responsibility and authority for creating a risk-based assessment system, maintaining a viable deposit insurance fund, supervising State nonmember banks, acting as backup supervisor for all insured banks, and resolving failed institutions. Congress has not mandated that the FDIC establish separate divisions for its insurance and supervision functions and, in general, Congress has left the FDIC's internal organization to the FDIC, although there are exceptions. For example, the FDIC is required to have a separate asset disposition division. While FMIC's internal structure is important, consideration also should be given to ensuring that FMIC has clear statutory responsibilities and authorities and sufficient discretion to respond to varying circumstances.

Q.3. The FDIC currently manages exposure risk to the deposit insurance fund (DIF) at the time when insurance is granted to an institution but also while the insurance stays in force. In determining membership eligibility, the FDIC considers factors including financial history and condition of an institution, adequacy of the institution's capital structure, and a number of other factors. If there is one thing that Community Banks do not need it is one more Federal agency requesting information, doing examinations, and layering additional standards and requirements onto them, which is time consuming and costly to the institution. To this end, do you think that institutions that are approved for FDIC insurance should be approved with far less rigor to have access to the FMIC insurance fund? Do you think that there could be coordination between the FDIC and the FMIC on the FDIC's ongoing monitoring and reporting requirements?

A.3. As the primary Federal regulator of most community banks, the FDIC understands the crucial role that community banks play in the American financial system. The FDIC has an ongoing responsibility to better understand the challenges facing community banks, and in early 2012 we launched a series of initiatives focusing on confronting those challenges. These initiatives remain an ongoing priority and include outreach programs, research, and improvements to make the supervisory process for community banks more efficient, consistent, and transparent.

Under the bill the Committee is considering, the FMIC would have to consider various factors before approving participation by four types of companies: private mortgage insurers, servicers, issuers, and bond guarantors. The factors for approving each of these companies are similar to, but not the same as, the statutory factors found in section 6 of the FDI Act, 12 U.S.C. §1816, which the FDIC uses to determine eligibility for Federal deposit insurance. The FDI Act factors include the financial history and condition of the institution, adequacy of the capital structure, future earnings prospects, general character and fitness of management, risk presented to the DIF, convenience and needs of the community to be served, and the consistency of the institution's corporate powers with the purposes of the FDI Act.

However, a bank's condition can change over time. For example, a change in ownership or business model can alter a bank's risk profile. Some banks are mismanaged or take on excessive risk, which can cause problems for the bank. If problems are severe enough, they can result in the bank's failure. Because a bank's condition can change over time, the FDIC and the other Federal banking regulators are statutorily required to continue to monitor the condition of every bank after the bank receives deposit insurance. For example, every bank must file a quarterly report of condition and income. The FDIC and other banking regulators conduct periodic on-site examinations and require banks to take remedial action when deficiencies are noted.

The FMIC would be tasked with assessing potential risks of market participants in the secondary mortgage market, which is a different assessment than the FDIC makes for members of the deposit insurance system. Congress may wish to give the FMIC the authority to make the final determination on whether an institution has access to the FMIC insurance fund. Of course, to the extent there is overlap in the supervisory authority or requirements for granting admission to the deposit insurance system and for participation in the FMIC mortgage insurance system, it will be important for the FDIC, other banking regulators, and the FMIC to coordinate their efforts to avoid undue burden on participants of both systems. Under the FDI Act, the FDIC coordinates with other Federal and State regulators, and the FDIC works on interagency issues through the Federal Financial Institutions Examination Council. Additionally, the FDIC has a longstanding Memorandum of Understanding with the other banking regulators (OCC, FRB, and the former OTS) to facilitate a coordinated approach to supervision. Where entities subject to the legislation are subject to oversight by other Federal or State agencies, the legislation could clarify requirements for coordination of examination activities and information sharing agreements.

Q.4. The new FMIC will oversee a deposit-like insurance fund. Since it will have to be at least partially funded from day-1 of the new operation, how do you suggest that we consider getting initial capital for the fund? Do you recommend a gradual increase in premiums over time?

A.4. The FMIC guarantee will cover an insurance exposure that generally rises with the volume of mortgages securitized under the FMIC. In recognition of this fact, the draft legislation mandates certain target levels for the size of the Mortgage Insurance Fund (MIF) in terms of a percentage of outstanding balances. This is analogous to the statutory reserve targets mandated for the FDIC Deposit Insurance Fund (DIF), which are expressed as a percent of estimated insured deposits.

While the proposed legislation suggests that FMIC would assess participants only at issuance (similar to the manner in which the Government-sponsored mortgage enterprises (GSEs) currently impose guarantee fees), as opposed to an ongoing basis like the FDIC, it does not state so unambiguously.

Whichever assessment model the legislation or FMIC ultimately adopts, the FDIC's experience suggests that maintaining relatively consistent assessment rates over time will be important in avoiding procyclicality in insurance assessments and in providing for a stable competitive landscape between insured and noninsured financial activities. In that regard, the FDIC has learned from its experience that the flexibility to determine the proper fund size is important and that a hard target for a fund (that is, a particular size that a fund must remain) poses problems. During the 1990s through 2006, when Congress required a hard target for the size of the FDIC's insurance fund, a number of problems resulted, including a decade where at least 90 percent of the industry paid nothing for deposit insurance, a free-rider problem where new entrants and fast growers diluted the fund but paid nothing, and potentially volatile and procyclical premiums.

Also, as our experience during the recent crisis shows, the net worth of the insurance fund at any given time is less important than the availability of cash, or working capital, to meet anticipated near-term insurance obligations. As such, there are a wide range of potential options for providing initial working capital to the FMIC, including an entrance fee for participating institutions, or loans from the Federal Government or the participating institutions themselves.

Q.5. Also, you note that while a risk-based pricing system that is forward looking works much better than the former flat-rate system for the FDIC, you also note that this is not analogous with the Federal mortgage insurance which might have alternative means of mitigating risk through underwriting standards, etc. Do you, however think that there should be a graduated scale for insurance premiums, where larger users of the system pay more for the insurance—perhaps based on asset size or loan origination?

A.5. The FDIC supports a risk-based pricing structure for deposit insurance. Under this system, banks that take on more risk pay more in deposit insurance, reducing the moral hazard problem. A Federal mortgage insurer, however, is likely to have a greater ability to mitigate risk at the outset than the FDIC has, for example, by setting robust underwriting standards for the underlying mortgages.

In the event that a gradual pricing scale or a system that differentiates between large and small FMIC users is adopted, it may not serve the same function as a risk-based pricing system. Under the FDI Act, the FDIC is permitted to establish separate risk-based assessment systems for large and small banks. The FDIC has different methods for assessing large and small banks, but these separate pricing systems do not usually produce dramatically or systematically higher or lower average rates for either of these groups of banks. In fact, the range of possible assessment rates is the same under both systems. Moreover, recent changes to the deposit insurance assessment system under the Dodd-Frank Act shifted more of the assessment burden from community banks to the largest institutions in order to better reflect each group's share of industry assets.

Whatever pricing system is adopted for Federal mortgage insurance, it is important that community banks have fair and equitable access to the secondary market for mortgages and to FMIC guarantees on terms that are not more expensive than for larger issuers. Without the ability for community banks to aggregate and securitize their loans, the scale economies in origination, servicing, and securitization could well impede the ability of community banks to compete in mortgage securitization.

Q.6. It seems apparent that the Federal Government does not always price insurance appropriately. You note that through prefunding, the FDIC is able to "smooth the cost" of insurance over time. However, the Designated Reserve Ratio (DRR) is truly a "soft target" and that it can often fluctuate which has led to instances when premiums are required to be increased during a crisis. How can we avoid instances where the FMIC will need to increase premiums during times of economic stress-times when institutions need to hold on to as much capital as possible? Doesn't having the ability to change rates inherently add the perverse incentive that industry will lobby the agency to lower rates during good times only to have to rates painfully increased during times of stress?

A.6. The FDIC faces the problem of procyclical assessments, and in fact has charged procyclical assessments in the past, with high assessment rates during and immediately after the last two major banking crises and low average assessment rates between the crises. Under new authorities granted under the Dodd-Frank Act, however, the FDIC has adopted a long-term target for the fund that should allow us to reduce procyclicality, while assuring that the DIP has sufficient funds to remain positive even during crises of the magnitude of the last two. In meetings between the FDIC and individual bankers and banking industry trade groups, the industry has consistently supported the idea of avoiding procyclical assessments.

The FDIC has learned from its experience that the flexibility to determine the proper fund size is important and that a hard target for a fund (that is, a particular size that a fund must remain) poses problems. As discussed above, an inherent conflict exists between maintaining constant rates and a specific, hard target fund size. During the 1990s and through 2006, Congress required a hard target for the size of the FDIC's insurance fund, which resulted in a decade where at least 90 percent of the industry paid nothing for deposit insurance. In contrast, allowing the fund to grow during good times should reduce premium procyclicality.

There are some significant differences between how the FDIC and the proposed FMIC would generate income, however. The FDIC assesses on bank liabilities every quarter, while the FMIC would assess transactions. FMIC's transaction-based assessments also may increase and decrease procyclically, that is, in line with overall economic activity. Congress may wish to consider ways to ameliorate this procyclical bias, for example, by charging sufficient fees during good times to build a fund large enough to withstand losses during a downturn.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM KURT REGNER

Q.1. What is needed in legislation to ensure that Federal and State regulators coordinate on supervision and resolution?

A.1. Legislative text should include the requirement that prior to taking any action that directly or indirectly affects a regulated insurance legal entity, including, but not limited to the approvals to work with the GSE's or guarantee covered bonds, a Federal regulator, at bare minimum must consult with the domestic State insurance regulator or similar official. Additionally, the legislation should defer to State regulators on any action related to insurance legal entities.

Attachment B contains recommended changes to S.1217 that would ensure coordination and appropriate deference to State insurance regulators.

Q.2. S.1217 proposes the regulator have, with the consent of other officials, emergency powers in a crisis that only lasts 6 months. Should we consider expanding that authority, or providing other countercyclical tools that a regulator may need in a future crisis?

A.2. Yes, it would be advisable to permit the exercise of emergency powers for up to 2 years. It would be advisable to revise Section 205 to provide a reporting mechanism to Congress, whereby the Corporation would make a written report to Congress within 30 days of exercising the authority provided by Section 205 (a) explaining the unusual and exigent circumstances and the policies devised or under consideration to address the situation.

The private mortgage insurance regulations that we have in place are intended to deal with ups, downs, and sudden shocks, not an extended period of intense crisis. Assuming the rare occasion of systemic crisis in which regulators have exhausted their existing tools to encourage participation in the market, the capability of providing capital and liquidity in a time of crisis to jumpstart the market could be a useful tool and may also encourage entry in normal times. An additional power in time of crisis that could be useful would be the ability to adjust and lower the first loss percentage position. Requiring a reinsurance backstop related to legacy business is also a possibility.

It would be advisable to revise Section 211 to allow the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury in consultation with the Director of the Federal Mortgage Insurance Corporation to increase or decrease the minimum downpayment requirement for an eligible mortgage on a temporary basis of up to 1 year as an additional macroeconomic management tool. Continuation of any extension of a change in the default downpayment requirement in excess of 1 year should require the approval of Congress.

Section 218 should allow for consultation and information sharing with State regulators for private mortgage insurers and bond guarantors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KIRK FROM KURT REGNER

Q.1. You mention that financial guarantors have "substantial experience in the [housing] area but failed to live up to expectations during financial crisis and, given our experience to date, insurance regulators remain skeptical of their capability of insuring anything other than municipal debt." Would you agree that the monoline financial guarantors did not even perform well during the financial crisis for municipal debt?

A.1. I respectfully disagree. The most recent crisis saw losses paid on nonmunicipal securities increase substantially in 2008 to over $4 billion and stay at elevated levels since the crisis. Meanwhile, losses paid on municipal securities have remained below $300 million—an easily manageable amount for an industry with a notional exposure of $1.4 trillion—during each of these same periods, thus demonstrating the pressure put on financial guaranty insurers' capitalization that had been caused by the housing market.

Q.2. The recent financial crisis exposed weaknesses in both mortgage insurers as well as monoline bond insurers (most notable examples being Ambac and MBIA), yet you also claim that the existing regulatory structure works well. If Congress enacts legislation that enables Bond Guarantors and/or mortgage insurers to have a more robust role in the housing finance system, do you not believe that the standards and regulatory oversight of that function should be done at the national level?

A.2. State regulators have the necessary tools and authority to regulate private mortgage insurers and bond guarantors to the level necessary to maintain a stable housing finance system at the local level. Although they are different products, the Federal Government already relies on State regulators to oversee homeowners insurance, renters insurance, and title insurance which are every bit as instrumental to ensuring a functioning housing market. We would encourage Congress to continue to rely on and defer to the century and half of experience State regulators have in balancing solvency with product availability and affordability. I would encourage Federal efforts instead to focus on the activity by the institutions they appropriately regulate—ensuring lenders do not engage in the underwriting practices that led to the last crisis and exposed mortgage and bond insurers to extreme risks.

MORTGAGE GUARANTY INSURANCE MODEL ACT

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Section 1. Title

This Act may be cited as the Mortgage Guaranty Insurance Act.

Section 2. Definitions

The definitions set forth in this Act shall govern the construction of the terms used in this Act but shall not affect any other provisions of the code.

A. "Authorized real estate security," for the purpose of this Act, means an amortized note, bond or other evidence of indebtedness, not exceeding ninety-five percent (95%) of the fair market value of the real estate, secured by a mortgage, deed of trust, or other instrument that constitutes, or is equivalent to, a first lien or charge on real estate; provided:

(1) The real estate loan secured in this manner is one of a type that a bank, savings and loan association, or an insurance company, which is supervised and regulated by a department of this state or an agency of the federal government, is authorized to make, or would be authorized to make, disregarding any requirement applicable to such an institution that the amount of the loan not exceed a certain percentage of the value of the real estate;

(2) The improvement on the real estate is a building or buildings designed for occupancy as specified by Subsections A(1) and A(2) of this section; and

(3) The lien on the real estate may be subject to and subordinate to the following:

(a) The lien of any public bond, assessment or tax, when no installment, call or payment of or under the bond, assessment or tax is delinquent; and

(b) Outstanding mineral~~mineral,~~ oil, water or timber rights, rights-of-way, easements or rights-of-way of support, sewer rights, building restrictions or other restrictions or covenants, conditions or regulations of use, or outstanding leases upon the real property under which rents or profits are reserved to the owner thereof.

B. "Book year" refers to the year in which the mortgage originated. Book years over 6 years in the past may be combined.

C. "Bulk Mortgage Guaranty Insurance" means mortgage guaranty insurance that provides coverage under a single transaction on each mortgage loan included in a defined portfolio of loans that have already been originated.

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~~C~~D. "Contingency reserve" means an additional premium reserve established to protect policyholders against the effect of adverse economic cycles.

~~D~~E. "Loss" refers to losses, defense and cost containment and loss adjustment expenses excluding costs which have already been expensed.

~~E~~F. "Mortgage guaranty insurance" is:

(1) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, provided the improvement on the real estate is a residential building or a condominium unit or buildings designed for occupancy by not more than four families;

(2) Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, providing the improvement on the real estate is a building or buildings designed for occupancy by five (5) or more families or designed to be occupied for industrial or commercial purposes; and

(3) Insurance against financial loss by reason of nonpayment of rent or other sums agreed to be paid under the terms of a written lease for the possession, use or occupancy of real estate, provided the improvement on the real estate is a building or buildings designed to be occupied for industrial or commercial purposes.

~~F~~G. "Mortgage Guaranty Insurance Industry Loan Level Capital Standards" means mortgage detail loan level cash flow projection reporting adopted by the mortgage guaranty insurance industry.

~~G~~H. "Mortgage Guaranty Insurance Modified RBC Standards" means property and casualty risk based capital (RBC) methodology modified to recognize risk and control elements unique to the mortgage guaranty insurance industry.

~~H~~I. "Mortgage Guaranty Insurance Standards Manual" for purposes of this Act, means the current version of the *Mortgage Guaranty Insurance Standards Manual* developed and adopted by the National Association of Insurance Commissioners (NAIC) and as amended from time to time. A change in the Mortgage Guaranty Insurance Standards Manual shall be effective on January 1 following the calendar year in which the change has been adopted by the NAIC if such change is adopted on or before September 1st. A change in the Mortgage Guaranty Insurance Standards Manual shall be effective on the second January 1 following the calendar year in which the change has been adopted by the NAIC if such change is adopted after September 1st.

~~I~~J. "Mortgage Guaranty Quality Control Program" means an early detection warning system for potential solvency risk issues within a mortgage guaranty insurer.

~~J~~K. "NOD" means notice of delinquency.

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~~K~~L. "NOD policy" refers to a policy for which a NOD has been received and for which a loss reserve has been established.

~~L~~M. -"Non-NOD policy" refers to a policy for which no NOD has been received or for which
no loss reserve has been established.

~~M~~N. "Persistency" refers to the probability that an existing policy will renew.

O. "Pool Mortgage Guaranty Insurance" means mortgage guaranty insurance that provides coverage under a single transaction on a defined portfolio of loans for losses up to an aggregate limit.

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~~N~~P. "Time-frame" refers to all calendar years subsequent to the as of date at which loss reserves are estimated. The next 5 calendar years will be listed separately, and calendar years subsequent combined unless the domiciliary regulator requests a longer time frame.

Section 3. Capital and Surplus

A. A mortgage guaranty insurance company shall not transact the business of mortgage guaranty insurance unless, if a stock insurance company, it has paid-in capital of at least $10,000,000 and paid-in surplus of at least $15,000,000, or if a mutual insurance company, a minimum initial surplus of $25,000,000. A stock company or a mutual company shall at all times thereafter maintain a minimum policyholders' surplus of at least $20,000,000.

B. Mortgage guaranty insurers formed prior to passage of this Act may maintain the amount of capital and surplus or minimum policyholders' surplus previously required of them by statute or administrative order for a period not to exceed twelve months following the effective date of the adoption of the Mortgage Guaranty Insurance Act amendments.

C. The commissioner may by order reduce the minimum amount of capital and surplus or minimum policyholders' surplus required under sub. (1) for an affiliated reinsurer that is or will be engaged solely in the assumption of risks from affiliated mortgage guaranty insurers, if in the commissioner's opinion, the business plan and other relevant circumstances of the affiliated reinsurer justify the proposed reduction in requirements.

~~insurance unless, if a stock insurance company, it has paid-in capital of at least $1,000,000 and paid-in surplus of at least $1,000,000, or if a mutual insurance company, a minimum initial surplus of$2,000,000. A stock company or a mutual company shall at all times thereafter maintain a minimum policyholders' surplus of at least $1,500,000.~~

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Section 4. Insurer's Authority to Transact Business

No mortgage guaranty insurance company may issue policies until it has obtained from the commissioner of insurance a certificate setting forth that fact and authorizing it to issue policies.

Section 5. Geographic Concentration

A. **Aggregate Loan Limits** – A mortgage guaranty insurance company shall not expose itself to any loss on any one risk in an amount exceeding ten percent (10%) of its surplus to policyholders. Any risk or portion of risk which has been reinsured shall be deducted in determining the limitation of risk ~~insure loans secured by a single risk in excess of ten percent (10%) of the company's aggregate capital, surplus and contingency reserve.~~

~~B. No mortgage guaranty insurance company shall have more than twenty percent (20%) of its total insurance in force in any one Standard Metropolitan Statistical Area (SMSA), as defined by the United States Department of Commerce.~~

B. **State Concentration Limits** – A mortgage guaranty insurance company's business writings shall maintain compliance with geographical state concentration limits based on a sliding scale associated with the company's scope and size of multi-state operations, as follows:

(1) Large multi-state operations, defined as a mortgage guaranty company which directly writes business in 30 or more states, shall limit its gross business writings in any one state to no more than ten percent (10%) of total premiums written.

(2) Medium multi-state operations, defined as a mortgage guaranty company which directly writes business in 15 or more states but less than 30 states, shall limit its gross business writings in any one state to no more than fifteen percent (15%) of total premium written.

(3) Small multi-state operations, defined as a mortgage guaranty company which directly writes business in less than 15 states, shall not be impacted by the above sliding scale limits, but subject to additional Capital Requirements, as described under (C).

C. ~~The provisions of this section shall not apply to a mortgage guaranty insurance company until it has possessed a certificate of authority in this state for three (3) years.~~**Capital Requirements** – Any mortgage guaranty insurance company business writings exceeding the above state maximum limits shall be subject to an additional capital requirements penalty to recognize the level of business concentration risk inherent in the company's operations, in accordance with the mortgage guaranty risk based Capital Standards described under Section 12, based on the following:

(1) Large multi-state operations requirements shall be based on individual states where gross premium written exceeds the limits established under (B).

(2) Medium multi-state operations requirements shall be based on individual states where gross premium written exceeds the limits established under (B).

(3) Small multi-state operations requirements shall be based on total company gross premium written.

D. **Concentration Limit Applicability** – The provisions of this section shall be effective only for new business written beginning January 1, following the calendar year in which the Mortgage Guaranty Insurance Act amendments have been adopted by the NAIC.

E. **Concentration Limit Exclusions** - The provisions of this section shall not apply to a mortgage guaranty insurance company's business written prior to the adoption of the Mortgage Guaranty Insurance Act amendments, subject to the company submission of an acceptable written plan to the state of domicile insurance commissioner outlining measures to achieve compliance with applicable state concentration limit exceptions.

Section 6. Advertising

No mortgage guaranty insurance company or an agent or representative of a mortgage guaranty insurance company shall prepare or distribute or assist in preparing or distributing ~~any brochure, pamphlet, report or~~ any form of advertising to the effect that the real estate investments of any financial institution are "insured investments," unless the ~~brochure, pamphlet, report or~~ advertising clearly states that the loans are insured by mortgage guaranty insurance companies possessing a certificate of authority to transact mortgage guaranty insurance in this state or are insured by an agency of the federal government, as the case may be.

Section 7. ~~Investment Limitation~~Restrictions on Investments Secured by Real Estate or Mortgages

A Mortgage Guaranty Insurance company's investment in mortgage and real estate not directly related to the ordinary conduct of their business shall be restricted as follows:

A. **Investment Restrictions** - A mortgage guaranty insurance company shall not invest in notes or other evidence of indebtedness secured by a mortgage or other lien upon real property. This section shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contract of sale are acquired in the course of good faith settlement of claims under policies of insurance issued by the mortgage guaranty insurance company, or in the good faith disposition of real property, so acquired.

B. **Capital Requirements** - Any investment in such notes or evidences of indebtedness secured by a mortgage or other lien upon real property, including residential mortgage-backed securities, not otherwise permitted under this section, shall be subject to an additional capital requirements penalty, in accordance with the mortgage guaranty risk based Capital Standards described under Section 12, as it relates to:

(1) Mortgage securities backed by full faith and credit of U.S. Government; and

(2) Mortgage securities not backed by the full faith and credit of U.S. Government.

Drafting Note: The intent of the above modified RBC calculation will be to minimize the risk of Mortgage Guaranty Insurers becoming overly exposed to the real estate market. This Section imposes higher capital requirements on Mortgage Insurers with mortgage related investments.

~~A. A mortgage guaranty insurance company shall not invest in notes or other evidences of indebtedness secured by mortgage or other lien upon real property. This section shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contracts of sale are acquired in the course of the good faith settlement of claims under policies of insurance issued by the mortgage guaranty insurance company, or in the good faith disposition of real property so acquired.~~

~~B.~~

~~Any investment in notes or other evidences of indebtedness secured by mortgage or other lien upon real property, including residential mortgage backed securities, not otherwise permitted under this section, cannot be counted toward meeting any capital requirements under Section 10~~

Section 8. ~~Coverage Limitation~~Reinsurance

A. A mortgage guaranty insurance company shall retain at least twenty-five percent (25%) of the entire indebtedness to the insured, if any portion of the indebtedness to the insured is ceded to one or more reinsurers, unless a lesser retention is approved in writing by the domiciliary commissioner.

B. No mortgage guaranty insurance company shall enter into captive reinsurance arrangements which involve the direct or indirect ced~~e~~ing of any portion of its insurance risks or obligations to a reinsurer owned or controlled by an insured; any subsidiary or affiliate of an insured; an officer, director or employee of an insured or any member of their immediate family; a corporation, partnership, trust, trade association in which an insured is a member, or other entity in which an insured or an officer, director or employee or any member of their immediate family has a financial interest; or any designee, trustee, nominee or other agent or representative of any of the foregoing.

C. No mortgage guaranty insurer shall enter into reinsurance arrangements with its affiliates after January 1 of the year following adoption of these Mortgage Guaranty Insurance Act amendments, unless it has obtained appropriate approval by the commissioner of the state of domicile.

D. External reinsurance relationships shall comply with minimum financial quality standards including the following:

(1) The reinsurance agreement and segregated account or trust arrangements shall be submitted to the commissioner of the state of domicile for approval.

(2) The reinsurer shall establish and maintain required unearned premium, contingency and loss reserves in a segregated account or segregated trust.

(3) If the reinsurer establishes a segregated trust, the reinsurance agreement shall provide that:

(a) The segregated trust shall be in a form approved by the commissioner of the state of domicile.
(b) The commissioner shall approve any amendments to the reinsurance agreement before becoming effective.
(c) The ceding mortgage guaranty insurer shall have the right to terminate the ceding of additional insurance under the reinsurance agreement if so ordered by the commissioner.
(d) The commissioner has the right to request from the assuming reinsurer information concerning its financial condition.
(e) The assuming reinsurer shall notify the commissioner of any material change in its financial condition.
(f) The reinsurance agreement may not limit liability for losses to the assets held in a segregated trust.

~~A.~~E. In lieu of payment of its limit of coverage, a mortgage guaranty insurance company may elect to pay the entire indebtedness to the insured and acquire title to the authorized real estate security.

Section 9. Mortgage Guaranty Insurance as Monoline

A. A mortgage guaranty insurance company that anywhere transacts any class of insurance other than mortgage guaranty insurance is not eligible for the issuance of a certificate of authority to transact mortgage guaranty insurance in this state nor for the renewal thereof.

B. A mortgage guaranty insurance company that anywhere transacts the classes of insurance defined in Section 2A(2) or 2A(3) is not eligible for a certificate of authority to transact in this state the class of mortgage guaranty insurance defined in Section 2A(1). However, a mortgage guarantee insurance company that transacts a class of insurance defined in Section 2A may write up to five percent (5%) of its insurance in force on residential property designed for occupancy by five (5) or more families.

Section 10. Underwriting ~~Discrimination~~ Standards

A. No policy of mortgage guaranty insurance, excluding policies of reinsurance, shall be written unless it is based on a reasonable and thorough examination and assessment of evidence that prudent underwriting standards have been met by the originator of the mortgage either before the inception of coverage for business generally, or, for Bulk Mortgage Guaranty Insurance or Pool Mortgage Guaranty Insurance, within 90 days following the inception of coverage.

B. Mortgage guaranty insurers shall establish formal underwriting guidelines which set forth the basis for concluding that prudent underwriting standards have been met. Such underwriting guidelines shall, as a minimum, include an assessment of mortgage loan credit quality based on the following factors:

(1) The type and characteristics of the mortgage loan;

(2) A borrower's credit-worthiness and loan repayment ability, which must, at a minimum, obtain and maintain documents verifying a borrower's income; and

(3) A property's marketability qualifications which must, at a minimum, include receipt and maintenance of supporting appraisal documentation.

C. Underwriting guidelines must be reviewed and approved by management and the board of directors of a mortgage guarantee insurer and be communicated across the organization to promote consistent business practices.

D. Mortgage guaranty underwriting guidelines shall incorporate documentation and approval requirements in key control areas to support the underwriting evaluation, which shall include but not be limited to the following:

(1) Lender loan submission requirements;

(2) Loan documentation and underwriting compliance evaluation responsibilities;

(3) Minimum mortgage documentation standards;

(4) Loan program or type qualification requirements;

(5) Minimum borrower repayment qualification requirements; and

(6) Minimum property marketability qualifications.

Mortgage guaranty insurer considerations in the establishment of the documentation and approval requirements outlined above include the following, based on the appropriateness in relation to the size and status of the mortgage guaranty insurer's organization and mortgage loan environment:

(1) **Lender Loan Submission Requirements** – Loan submission shall include identification of requirements for loan application processing under scenarios

involving both loan document submission by loan originators to the mortgage guaranty insurer and electronic submission of summary loan data without documents.

(2) **Loan Documentation and Underwriting Compliance Evaluation Responsibilities** – Loan documentation and underwriting evaluation responsibilities shall include but not be limited to the following:

(a) Lender responsibilities for loan data entry accuracy and providing loan documentation supporting the loan file information submitted electronically;
(b) Mortgage guaranty insurer's responsibilities for verifying loan data entry accuracy and compliance with loan document submission procedures;
(c) Automated underwriting systems reliance for verification of loan underwriting decisions and compliance with loan document and electronic submission procedures;
(d) Lender obligations to provide underlying loan documents based on subsequent mortgage guaranty insurer request; and
(e) Mortgage guaranty insurer and insured's rescission rights and responsibilities to demonstrate transparency in accordance with Section 18.

(3) **Minimum Mortgage Documentation Standards** – Mortgage documentation standards shall include but not be limited to:

(a) Loan application;
(b) Mortgage insurance application;
(c) Credit history reports and sources;
(d) Borrower income verification and sources;
(e) Borrower employment verification;
(f) Property appraisal reports;
(g) Mortgage note evidence of indebtedness; and
(h) Commitment certificate.

(4) **Loan Program or Type Qualification Requirements** – Loan program requirements shall include but not be limited to:

(a) Loan purpose;
(b) Property type;
(c) Maximum loan to value;
(d) Maximum loan terms;
(e) Maximum loan amount;
(f) Minimum credit score under any credible scoring system; and
(g) Maximum debt to income ratio.

(5) **Minimum Borrower Repayment Qualification Requirements** – Borrower repayment requirements shall include but not be limited to:

(a) Borrower's credit history;

(b) Borrower's sources of funds;

(c) Borrower's credit score under any credible scoring system;

(d) Borrower's debt to income ratio; and

(e) Borrower's down payment.

(6) **Minimum Property Marketability Qualifications** – Property marketability requirements to support the reasonableness of the mortgaged property's valuation shall take into account:

(a) Marketability, as demonstrated by property appraisals for comparable properties or other equivalent comparisons; and

(b) Valid property title, as demonstrated by title insurance or other equivalent legal opinion or state coverage programs.

E. Material amendments to a mortgage guaranty insurer's underwriting guidelines shall be filed with the state of domicile.

F. Nothing in this chapter shall be construed as limiting the right of a mortgage guaranty insurer to impose reasonable requirements upon the lender with regard to the terms of a note or bond or other evidence of indebtedness secured by a mortgage or deed of trust, such as requiring a stipulated down payment by the borrower.

G. No mortgage guaranty insurance company may discriminate in the issuance or extension of mortgage guaranty insurance on the basis of the applicant's sex, marital status, race, color, creed or national origin.

Drafting Note: States and jurisdictions should consult their constitution or comparable governance documents and applicable civil rights legislation to determine if broader protections against unacceptable forms of discrimination should be included in Section 10G.

~~Each mortgage guaranty insurer shall have formal written underwriting guidelines that shall be consistent with the standards for underwriting guidelines established by the Mortgage Guaranty Insurance Standards Manual.~~

~~Nothing in this chapter shall be construed as limiting the right of a mortgage guaranty insurance company to impose reasonable requirements upon the lender with regard to the terms of a note or bond or other evidence of indebtedness secured by a mortgage or deed of trust, such as requiring a stipulated down payment by the borrower.~~

~~No mortgage guaranty insurance company may discriminate in the issuance or extension of mortgage guaranty insurance on the basis of the applicant's sex, marital status, race, color, creed or national origin.~~

~~No policy of mortgage guaranty insurance, excluding policies of reinsurance, shall be written unless and until the insurer has conducted a reasonable and thorough~~

~~examination of the evidence supporting credit worthiness of the borrower and the appraisal report reflecting market evaluation of the property and has determined that prudent underwriting standards have been met.~~

Section 11. Policy Forms and Premium Rates Filed

A. All policy forms and endorsements shall be filed with and be subject to the approval of the commissioner. With respect to owner-occupied, single-family dwellings, the mortgage guaranty insurance policy shall provide that the borrower shall not be liable to the insurance company for any deficiency arising from a foreclosure sale.

B. In addition, each mortgage guaranty insurance company shall file with the department the rate to be charged and the premium including all modifications of rates and premiums to be paid by the policyholder.

C. Every mortgage guaranty insurance company shall adopt, print and make available a schedule of premium charges for mortgage guaranty insurance policies. Premium charges made in conformity with the provisions of this Act shall not be deemed to be interest or other charges under any other provision of law limiting interest or other charges in connection with mortgage loans. The schedule shall show the entire amount of premium charge for each type of mortgage guaranty insurance policy issued by the insurance company.

NOTE: Open rating states may delete a portion or all of this provision and insert their own rating law.

Section 12. ~~Outstanding Total Liability~~Capital Standards

A. All mortgage guaranty insurers shall maintain adequate capital requirements based on the following:

1. **Tier 1 Risk Based Capital RBC Model Requirements** - A mortgage guaranty insurance company shall maintain an RBC score above the company action level based on the Mortgage Guaranty Insurance Modified RBC Standards.

2. **Tier 2 Loan Level Capital Model Requirements** - A mortgage guaranty insurance company shall provide the state of domicile insurance department with a detail loan level cash flow projection based on the uniform Mortgage Guaranty Insurance Industry Loan Level Capital Standards, upon the company's RBC score falling below the company action level.

3. **Business Writing Authority Requirements** - A mortgage guaranty insurance company shall cease writing new business until such time as its RBC ratio is no longer below the company action level or it has obtained appropriate waivers from the state of domicile insurance regulatory authorities.

4. **Dividend Restrictions** - A mortgage guaranty insurer whose RBC is below the company action level may not pay dividends to its shareholders and an affiliate of

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—the insurer may not accept such dividends unless the insurer reports the dividends
—to the state of domicile insurance department at least 30 days in advance before
—payment and the commissioner does not disapprove the dividends within that period.
— All dividend requests shall be required to include:

(a) —Ordinary dividends as defined under the state of domicile statutes;
~~(1)~~

(b) —Extraordinary dividends as defined under the state of domicile statutes; and

(c) —Actuarially verified financial projections that disclose the adequacy of the
—mortgage guaranty insurer's capital subsequent to its payment based upon
—scenarios as required by the commissioner of the state of domicile.

B. **Uniform Standard of Reporting** – Each mortgage guaranty insurer shall report its Tier 1 Risk Based Capital RBC Model Requirements and, if applicable, its Tier 2 Loan Level Capital Model Requirements to each jurisdiction for which it has a certificate of authority.

C. **Protection of Integrity of Capital Standards** – A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty-five (25) times its capital, surplus and contingency reserve. In the event that any mortgage guaranty insurance company has outstanding total liability exceeding twenty-five (25) times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds twenty-five (25) times its capital, surplus and contingency reserve. Total outstanding liability shall be calculated on a consolidated basis for all mortgage guarantee insurance companies that are part of a holding company system.

Drafting Note: While the risk-to-capital standard itself is insufficient to account for differences in risk among the numerous varieties of mortgage loans offered in the United States, the purpose of Section 12C is to allow for a period of time in which the new Tier 1 Risk Based Capital Model Requirements and Tier 2 Loan Level Capital Model Requirements can be tested and thereby establish confidence by insurance regulators and the public at large. It is further intended to prevent future changes to, and developments in, the capital standards resulting in weaker standards than established in the previous version of this Model Act.

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~~(2)~~

~~A mortgage guaranty insurance company shall not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty five (25) times its capital, surplus and contingency reserve. In the event that any mortgage guaranty insurance company has outstanding total liability exceeding twenty five (25) times its capital, surplus and contingency reserve, it shall cease transacting new mortgage guaranty business until such time as its total liability no longer exceeds twenty-five (25) times its capital, surplus and~~

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~~contingency reserve. Total outstanding liability shall be calculated on a consolidated basis for all mortgage guarantee insurance companies that are part of a holding company system.~~

Section 13. Rebates, Commissions and Charges

A. A mortgage guaranty insurance company shall not pay or cause to be paid either directly or indirectly, to any owner, purchaser, lessor, lessee, mortgagee or prospective mortgagee of the real property that secures the authorized real estate security or that is the fee of an insured lease, or any interest therein, or to any person who is acting as an agent, representative, attorney or employee of such owner, purchaser or mortgagee, any commission, or any part of its premium charges or any other consideration as an inducement for or as compensation on any mortgage guaranty insurance business.

B. In connection with the placement of any mortgage guaranty insurance, a mortgage guaranty insurance company shall not cause or permit the conveyance of anything of value, including but not limited to any commission, fee, premium adjustment, remuneration or any other form of compensation of any kind whatsoever to be paid to, or received by an insured lender or lessor; any subsidiary or affiliate of an insured; an officer, director or employee of an insured or any member of their immediate family; a corporation, partnership, trust, trade association in which an insured is a member, or other entity in which an insured or an officer, director or employee or any member of their immediate family has a financial interest; or any designee, trustee, nominee or other agent or representative of any of the foregoing, except for the value of the insurance itself or claim payments thereon as provided by contract or settlement.

C. No mortgage guaranty insurance company shall make a rebate of any portion of the premium charge shown by the schedule required by Section 11C. No mortgage guaranty insurance company shall quote any rate or premium charge to a person that is different than that currently available to others for the same type of coverage. The amount by which a premium charge is less than that called for by the current schedule of premium charges is an unlawful rebate.

D. The commissioner may, after notice and hearing, suspend or revoke the certificate of authority of a mortgage guaranty insurance company, or in his or her discretion, issue a cease and desist order to a mortgage guaranty insurance company that pays a commission, ~~or makes an unlawful~~ rebate, or makes any unlawful conveyance of value under this section in ~~willful~~ violation of the provisions of this Act. In the event of the issuance of a cease and desist order, the commissioner may, after notice and hearing, suspend or revoke the certificate of authority of a mortgage guaranty insurance company that does not comply with the terms thereof.

Section 14. Compensating Balances Prohibited

Except for commercial checking accounts and normal deposits in support of an active bank line of credit, a mortgage guaranty insurance company, holding company or any affiliate thereof is prohibited from maintaining funds on deposit with the lender for which the mortgage guaranty insurance company has insured loans. Any deposit account bearing interest at rates less than what is currently being paid other depositors on similar deposits or any deposit ~~in excess of amounts insured by an agency of the federal government~~for which there is no apparent or explicable business purpose shall be presumed to be an account in violation of this section. Furthermore, a mortgage guaranty insurance company shall not use compensating balances, special deposit accounts or engage in any practice that unduly delays its receipt of monies due or that involves the use of its financial resources for the benefit of any owner, mortgagee of the real property or any interest therein or any person who is acting as agent, representative, attorney or employee of the owner, purchaser or mortgagee as a means of circumventing any part of this section.

Section 15. Conflict of Interest

A. If a member of a holding company system, a mortgage guaranty insurance company licensed to transact business in this state shall not, as a condition of its certificate of authority, knowingly underwrite mortgage guaranty insurance on mortgages originated by the holding company system or an affiliate or on mortgages originated by any mortgage lender to which credit is extended, directly or indirectly, by the holding company system or an affiliate.

B. A mortgage guaranty insurance company, the holding company system of which it is a part, or any affiliate shall not as a condition of the mortgage guaranty insurance company's certificate of authority, pay any commissions, remuneration, rebates or engage in activities proscribed in Sections 13 and 14.

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves that accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans that have resulted in the conveyance of property that remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period that is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period that is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve subject to the following provisions:

(1). The mortgage guaranty insurance company shall automatically contribute to the contingency reserve an amount equal to fifty percent (50%) of the remaining unearned premiums.

(2) The mortgage guaranty insurer shall contribute an additional quarterly contingency reserve amount above the base level equal to ten percent (10%) of the remaining unearned premiums, to reflect macro-economic indicators of potential cyclical mortgage industry downturn based on the projections related to:

(a) Housing price indices growth rate decline of ten percent (10%) year over year based on the FHFA Housing Price Index (HPI) or a comparable successor index; or

(b) Unemployment rate increases above 8% based on the Bureau of Labor Statistics National Unemployment Rate.

(3) -Mortgage guaranty insurer ~~C~~contributions to the contingency reserve made during each calendar year shall be maintained for a period of 1~~2~~80 months, to provide for reserve buildup, except that withdrawals may be made by the company in any year in accordance with the provisions in Section 16C(4).

(4) Mortgage guaranty insurer contingency reserve early withdrawals in any year shall be subject to:

(a) ~~which the actual incurred losses exceed thirty five percent (35%) of the corresponding earned premiums.~~ ~~Amount restriction limitations equal to the amount necessary to meet minimum capital and surplus requirements only~~ Contingency reserves aged less than 180 months may only be released if minimum capital and surplus falls below the minimum statutory level due to adverse loss experience. The amount that may be released will be no more than the amount required to restore surplus to statutory minimums and shall not be made available for the payment of dividends; and

(b) No releases shall be made without prior approval by the commissioner of -insurance of the insurance company's state of domicile.

(5) In reviewing a request for withdrawal pursuant to this Section 16C, the insurer's domiciliary commissioner may consider loss developments and trends. If any portion of the contingency reserve for which withdrawal is requested is maintained by a reinsurer or in a segregated account or trust of a reinsurer, the domiciliary commissioner may also consider the financial condition of the reinsurer.

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~~If the coverage provided in this Act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.~~

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company that is properly licensed to provide reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this Act in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this Act.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction in which a mortgage guaranty insurance company subject to the requirement of this Act is also licensed to transact mortgage guaranty insurance require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of the larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this Act.

(2) -Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this Act as required by Subsections A and C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this Act may be computed and maintained as required previously.

F. Premium Deficiency Reserve

The following components of a premium deficiency reserve must be disclosed in the actuarial report and actuarial opinion summary by book year and calendar year. The components must be disclosed in the financial statement and actuarial opinion by ~~calendar~~book year. The company may be required to estimate the following quantities by additional subgroupings (i.e. fixed versus variable interest, term of the loan, documentation requirements, interest rate or any other subgrouping) at the discretion of the domiciliary regulator.

(1) An estimate of the anticipated loss, both gross and net of reinsurance, for the selected time-frame for all "non-NOD policies" using actuarially justifiable, reasonable and well documented assumptions with regard to frequency, severity and persistency for all properties regardless of whether those properties have or have not previously experienced payment delinquency;

(2) An estimate of anticipated commissions, acquisition costs and maintenance expenses for the selected time-frame;

(3) An estimate of anticipated premiums (including unearned premiums but excluding the portion of the premium allocated to contingency reserves) for the same subgroupings and time-frame used for losses using assumptions consistent with those used for losses;

(4) At the discretion of the domiciliary regulator, premiums, losses and expenses may be discounted using interest rates which have been actuarially documented as being conservative, i.e. lower than some reasonable weighted average of the risk-free rate and the company's historical rate of return; and

(5) If the sum of (1) plus (2) is greater than (3) for any combination of calendar year, book year, or other subgroup as defined in (F) above, the amount of the difference will be disclosed in the actuarial report and actuarial opinion

summary as a potential premium deficiency reserve. If the sum of (1) plus (2) is greater than (3) for any book year or subgroup of a book year (summed by calendar year), the difference will be disclosed as a ~~potential~~ premium deficiency reserve in the financial statement and actuarial opinion.

Section 17. Quality Assurance

All mortgage guaranty insurers shall establish a formal internal Mortgage Guaranty Quality Control Program, which provides an early detection warning system as it relates to potential solvency risk issues. This Mortgage Guaranty Quality Control Program shall provide for the documentation, monitoring, evaluation and reporting on the integrity of the ongoing loan origination process based on indicators of potential underwriting strategy and control inadequacies or non-compliance. A quality control program provides the organization with feedback, which can be used by management to establish or modify company loan origination policies and procedures.

A mortgage guaranty insurer shall establish a Mortgage Guaranty Quality Control Program ~~which is consistent with the standards of the Mortgage Guaranty Insurance Standards Manual and~~ which must address the following provisions, as adjusted to the size and status of the insurer's organization and mortgage guaranty environment:

A. **Segregation of Duties** - Administration of the quality control program shall be delegated to designated risk management, quality control or internal audit personnel, which are technically trained. Persons who administer the quality control program shall be prohibited from engaging in activities related to loan origination, pricing, underwriting and operations.

B. **Senior Management Oversight** - Quality control personnel shall provide periodic quality control reports to an enterprise risk management committee or other equivalent senior management level oversight body.

C. **Board of Director Oversight** - Quality control personnel shall provide periodic quality control reports to the board of directors or other committee of directors established to facilitate board of director oversight.

D. **Policy and Procedures Documentation** - Mortgage Guaranty Quality Control Program policies and procedures shall be formally established and documented, and shall include but not be limited to:

(1) Organizational responsibilities;

(2) Program objectives and purpose;

(3) Management underwriting performance objectives and targets;

(4) Scope of quality control review;

(5) Sampling methodology representative of loan origination environment;

(6) Frequency of reviews;

(7) Management and board of director oversight roles;

(8) Reporting levels and scope; and

(9) Corrective action requirements.

E. **Underwriting Risk Review** – Quality control review shall include an examination of underwriting risk including categorization of the insurer's exposure and compliance with risk tolerance levels associated with:

(1) Mortgage type;

(2) Loan to value;

(3) Credit score;

(4) Debt to income;

(5) Geographic region; and

(6) Restricted market targets.

F. **Lender Performance Reviews** – Quality control monitoring provisions shall include an assessment of lender performance expectations including:

(1) Lender underwriting volumes and trends; and

(2) Lender exception volume, recommendations and solutions.

G. **Underwriting Performance Reviews** – Quality control monitoring provisions shall assess underwriting guidelines compliance based on:

(1) Loan documentation compliance review;

(2) Selective verification of original loan data relied on including borrower income and employment status;

(3) Loan approvals outside of mortgage guaranty insurer authority limits;

(4) Mortgage guaranty insurer underwriter exception volumes; and

(5) Declined Loan compliance.

H. **Problem Loan Trend Reviews** – Quality control monitoring provisions shall assess prospective risks associated with:

(1) Delinquency Trends;

(2) Foreclosure Trends;

(3) Default Inventory Trends; and

(4) Persistency Trends.

I. **Underwriting System Change Oversight** - Underwriting system program changes shall be monitored to ensure the integrity of underwriting and pricing system programs, which could impact automated underwriting system decision making.

J. **Pricing and Performance Oversight** - Pricing controls shall be monitored to ensure that business segment pricing structures support applicable performance goals.

K. **Internal Audit Validation** - Periodic internal audits shall be conducted to validate compliance with the Mortgage Guaranty Quality Control Program.

L. **Regulator Access** – The regulator of the state of domicile shall be provided access to an insurer's Mortgage Guaranty Quality Control Program and authorization to review such a program during a financial regulatory examination. Nothing herein shall be construed to limit a regulator's right to access any and all of the records of an insurer in an examination or as otherwise necessary to meet regulatory responsibilities.

Section 18. Rescission

The right of rescission represents a legal course of action available to a mortgage guaranty insurer to restore parties to their original position, based on bank and/or borrower acts, which do not meet standards of good faith conduct and the exercise of sound discretion and intelligence, resulting in the presentation of a loan for mortgage guaranty insurance which does not meet acceptable risk tolerance requirements in accordance with the mortgage guaranty insurer's underwriting standards. Mortgage guaranty insurer rescission practices shall be governed by the following:

A. **Rescission Rights and Responsibilities** – All mortgage guaranty insurance company policies shall include a detailed description of provisions governing rescissions and cancellations, which specify the insurer's and insured's rights, obligations and terms under which those actions may occur to ensure transparency.

B. **Rescission Relief Provisions** – Mortgage guaranty insurance company rescission relief practices shall be in accordance with the following principles:

(1) Mortgage guaranty insurers may exercise an early rescission relief option based on evidence of:

(a) Mortgage guaranty insurer loan validation and acceptance through independent verification via re-underwriting of applicable loan files; and

(b) Minimum of one year's (12 monthly) timely loan payments.

(2) Mortgage guaranty insurers shall exercise mandatory rescission relief based on evidence of :

(a) Timely consecutive loan payments from the borrower's own funds based on the first payment due date for a period of 3 years (36 monthly payments) with no 30-day delinquencies; or
(b) Current loan status after 5 years (60 monthly payments) following loan origination if no more than two 30-day and no 60-day delinquencies.

(3) Mortgage guaranty insurers shall retain extension of rescission rights in instances of misstatements, misrepresentations, omissions, data inaccuracies or active efforts to deceive through submission of forged or fictitious information in connection with loan origination or closing for a period of 10 years, based on:

(a) Credible evidence of the existence of the above conditions; and
(b) Credible evidence of the materiality of the above conditions to the company's acceptance of risk.

C. **Re-pricing Provisions** – Mortgage guaranty insurers shall have the option to exercise loan re-pricing, when prudent, in lieu of rescinding coverage based on the following:

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(1) Rescission relief has not been granted based on the principles outlined in (B);

(2) Loan would have been eligible for coverage under alternative pricing; and

(3) Misstatements, misrepresentations, omissions or inaccuracies are not considered material based on reasonable mortgage guaranty insurer verification of appraisal value and borrower income.

D. **Claim Denials** – Mortgage guaranty insurers are required by law to follow the Unfair Insurance Practices Act in each state in which they are licensed as it relates to business practices that constitute unfair claim settlement or compromise practices.

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Section 19. Mortgage Guaranty Insurance Standards Manual

The National Association of Insurance Commissioners shall develop and adopt a *Mortgage Guaranty Insurance Standards Manual*, as amended from time to time, which shall include underwriting and quality assurance standards and such other information as the National Association of Insurance Commissioners shall deem appropriate.

Section ~~17~~20. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this Act.

Chronological Summary of Actions (all references are to the Proceedings of the NAIC).

1976 Proc. II 15, 17, 647, 686, 747-753 (adopted).
1979 Proc. I 44, 47-48, 49, 719, 968-969 (corrected).

ANNOTATIONS

MORTGAGE GUARANTY INSURANCE MODEL ACT

Section 5 Geographic Concentration

Annotation 1: This section addresses the mortgage guaranty insurance industry risks associated with geographical business mix concentrations.

Economic boom in the 2000's created a "housing bubble" characterized by a rise in housing prices and falling mortgage rates, which peaked in 2005-06, serving as a major trigger to the U.S. subprime mortgage crisis. The crisis was ignited by a rise in subprime mortgage delinquencies and foreclosures. Securitization through complex repackaging of subprime mortgages into investments further contributed to the financial crisis and subsequent recession beginning in 2008.

Following the housing market peak, housing prices experienced a significant fall, declining some 30% nationwide and more than 45% in selected markets, including Nevada, Arizona, Florida and California where the total past due averaged 9%-11%, as of December 2008. Economic studies have pointed to a strong, positive relationship between the rate of housing price deterioration in urban areas and the subsequent rate of mortgage delinquency and foreclosure. The fall in housing prices and decline in loan to value ratios limited the ability of borrowers to avoid loan delinquency by exercising prepayment, home sales or refinancing options. The financial crisis also contributed to a growth in unemployment rates and loss of retirement savings, impacting borrower ability to meet loan payments.

The New York Federal Reserve analysis of the top states with respect to mortgages 90 days or more delinquent at the end of 2011 indicated the following delinquent percentages and potential causes:

- Florida (18.02%) – Florida faced the third worst housing market crash with homes losing 48% of their value since the market peak. 44% of Florida mortgage loans were underwater. The state's unemployment rate of 9% represented the sixth highest in the nation.
- Nevada (13.57%) – Nevada's unemployment rate of 12%, represented the highest in the nation. The state held the most underwater mortgages at 61% of all mortgaged properties in Nevada. Housing prices were down 59% from their pre-crash peak.
- Arizona (7.63%) – Arizona experienced a higher than average unemployment rate of 8.6%. Home prices plummeted 48% since 2007. The state had the second highest percentage of mortgages underwater at 48%.
- California (7.57%) – California's high unemployment rate of 11% combined with a poor housing market drop of 42% from its peak and a 30% underwater mortgage rate served as contributing factors to the market crisis. The state ranked seventh with one in twelve mortgage holders in serious delinquency.

National mortgage loan delinquent rate trend analysis indicates that current mortgage delinquency rates in the above states have experienced improvements. Nevertheless, these historical trends demonstrate that local market conditions and differences in state laws with respect to the judicial foreclosure process, can and do impact regional delinquency and foreclosure experience. Accordingly, Mortgage Guaranty Insurance Model Act Amendments were designed to minimize the risk and strengthen control over geographic business mix by establishing:

1. Concentration limits by state
2. Additional capital requirements where limits are exceeded to strengthen enforcement

Section 7 Restrictions on Investments Secured by Real Estate or Mortgages

Annotation 2: This section addresses the mortgage guaranty insurance industry relationships and risks associated with the secondary mortgage market.

The secondary mortgage market represents a market for the sale of securities or bonds collateralized by the value of mortgage loans. Mortgage lenders or other specialized investment firms typically group together loans originated in the primary mortgage market for sale as collateralized mortgage obligations or mortgage backed securities for sale to investors, including insurance companies.

Principal parties involved in the secondary mortgage market include:

(1) Government National Mortgage Association (GNMA) – a wholly-owned government corporation, whose mortgage backed securities are guaranteed by the full faith and credit of the United States government

(2) Freddie National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC), federally chartered government-sponsored but privately owned entities, which are not backed by the full faith and credit of the United States government, although often considered as effective beneficiaries of this guarantee as a result of government rescue from insolvency during the recent mortgage crisis

The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) amended the Securities Exchange Act of 1934 to provide additional capital sources through improvement in the marketability of mortgage backed securities. The SMMEA effectively allowed:

(1) Federally chartered and regulated financial institutions to invest in mortgage-backed securities guaranteed by FNMA and FHLMC, although not backed by the full faith and credit of the U.S.

(2) Override of state investment laws to enable state chartered and regulated institutions to invest in such mortgage-backed securities

SMMEA initially resulted in exceptional residential mortgage market growth and expansion, triggered by the theory that default risk on an individual loan basis was generally deemed to be minimized under the loan aggregation process.

The above growth in the secondary mortgage market was, however, also considered a contributing factor to the recent housing market crisis beginning in 2007. On the downside, mortgage securitization increased default risk from the standpoint of reduction in alignment of mortgage loan originator and mortgage guaranty insurer interests and incentives to ensure borrower repayment credit quality. As a result, mortgage loan defaults, delinquencies and foreclosures increased associated with potential rating agency assignment of inflated credit ratings, lending standard deterioration and subprime borrowing.

Accordingly, Mortgage Guaranty Insurance Model Act Investment Limitation amendments are proposed to reduce potential mortgage guaranty insurer risks associated with portfolio concentrations in securities reflective of investment in the same industry risk as the mortgage guarantor's primary business. This encompasses securities which represent an ownership interest in or are secured directly or indirectly by a pool of mortgages or cash flows generated by a pool of mortgages.

Section 8 Reinsurance

Annotation 3: This section addresses the mortgage guaranty insurance industry risks associated with reinsurance.

Mortgage guaranty reinsurance has generally been limited to affiliate ceding in lieu of limited external reinsurance alternatives, which typically creates unnecessary overhead expenses with limited benefits.

Affiliate reinsurance has generally been executed under requirements that a mortgage guaranty insurer can not retain more than 25% of the total risk exposure related to the indebtedness of the insured.

Accordingly, Mortgage Guaranty Insurance Model Act amendment provisions emphasize greater reinsurance flexibility options through:

- Removal of the mortgage guaranty insurer maximum 25% risk retention limits
- Discouragement of affiliate reinsurance arrangements by the above adjustment of reinsurance requirements, thereby permitting mortgage guaranty insurers to achieve improved administrative efficiencies
- Financial quality standards compliance where external reinsurance programs are employed
- Prohibition of captive reinsurance arrangements

Section 10 Underwriting Standards

Annotation 4: This section addresses mortgage guaranty insurer underwriting and related environmental causes and risks associated with the recent mortgage loan sub-prime mortgage loan crisis.

Legacy private mortgage insurers have suffered significant losses from exposure to the recent downturn of the U.S. housing market, which contributed to the national recession. Housing price declines in recent years have created negative equity on a large scale, with homeowner debt exceeding property values.

Key factors driving mortgage performance have included mortgage type, age, inadequate borrower credit score, loan to value, and debt to equity relationships and delinquency status. Pending delinquencies, default inventory aging and eventual foreclosures have become major factors to achieving financial recovery.

Regulatory actions based on the level of losses associated with the above factors have resulted in ongoing emphasis on capital adequacy requirements, which has in turn restricted or prevented companies from writing new mortgage guaranty insurance business.

Policy rescissions have avoided some large insurer losses, while at the same time demonstrating the susceptibility to borrower misrepresentation and / or potential fraud.

The concentration of mortgage loan originations in limited banks has placed competitive pressures on mortgage guaranty insurers to accept loans of lower credit quality or face the consequences of reduced business volume. Captive reinsurance agreements have resulted in regulatory concerns for originating banks to command considerations from mortgage insurers. These industry-wide competitive pressures have resulted in increased loan default, delinquency and foreclosure rates associated with the acceptance of sub-prime credit loans and reduced documentation "no doc" loans.

Current Mortgage Guaranty Insurance Model Act requirements for measuring capital adequacy in terms of Minimum Policyholders Position (25 times company capital, surplus and contingency reserves) have typically been exceeded and not proven effective in monitoring risk. The above results suggest that more risk sensitive measures to ensure future solvency are desirable along with Model Act update to provide an increased proactive monitoring role, particularly in areas where guidance is limited or silent.

Accordingly, Mortgage Guaranty Insurance Model Act establishment of more formal underwriting guidelines are proposed, which serve to establish a supervisory framework to ensure that lenders are obtaining adequate documentation, undertaking effective verification of financial information including income, maintaining reasonable debt service coverage and loan to value ratios, and making reasonable inquiry to resolve problems without significant market disruption.

Section 12 Capital Standards

Annotation 5: This section addresses the mortgage guaranty insurance industry risks and controls associated with capital standards.

The current Mortgage Guaranty Insurance Model Act reflects the mortgage guaranty insurance industry historic requirements for a mortgage insurer to maintain a minimum amount of statutory capital relative to risk in force in order for the mortgage insurer to continue to write new business. The most common formulation of this risk to capital methodology allows for a maximum permitted risk to capital ratio of 25 to 1. The risk to capital ratio did not serve the mortgage industry exceptionally well during the recent mortgage sub-prime crisis, as the identification of potential solvency problems associated with the sub-prime crisis and economic downturn were generally recognized prior to the risk to capital ratio reaching the above 25 to 1 maximum.

The Property and Casualty Insurance Industry has historically utilized a Risk-Based Capital (RBC) methodology to provide a capital adequacy standard. However, mortgage and financial guaranty insurance companies have historically been exempted from this RBC requirement, based on the unique differences in operations. The RBC methodology is generally viewed as a standard which provides:

- Uniformity among state regulatory agencies as a basis for establishing hypothetical minimum capital level requirements compared to the company's actual capital level
- RBC calculation based on risk relationships by applying a set of actuarial risk factors to various asset, premium and reserve balances

- State of domicile regulatory authority to enforce timely action based on company, regulatory and mandatory action levels driven by the severity of solvency issues

Accordingly, the Mortgage Guaranty Amended Model Act seeks to ensure these advantages through emphasis on the development of a two-tier capital adequacy measurement standard encompassing:

Tier 1 Risk Based Capital (RBC) Model - Establishment of a base line capital standard ratio commonly recognized in the industry based on the RBC methodology, through incorporation of many similarities with the existing property and casualty insurance industry methodology and supplemented by modifications to recognize risk and control elements unique to the mortgage guaranty insurance industry.

Tier 2 Loan Level Capital Model - Establishment of a uniform detail loan level cash flow projection to further supplement the above RBC methodology, in instances where the RBC scoring results reflect the equivalent of a "company action level", and support company requirements to submit a detailed action plan to address potential solvency issues.

Development of the above models is under ongoing planning with anticipated utilization of external consulting services to maximize the benefits of current mortgage guaranty insurance industry projects to develop the framework for the loan level capital model and utilize such project research to facilitate development of unique mortgage guaranty risk components and rating factors under the modified RBC model.

Section 16 ~~Contingency~~ Reserves

Annotation 6:

This section addresses the mortgage guaranty insurance industry risks and controls associated with the Contingency Reserve practices.

Contingency reserves have historically served to provide an additional form of premium reserves to protect policyholders against the effect of adverse economic cycles. These reserves have been established based on an automatic provision calculation of 50% of premium written. Current reserve provisions are required to be maintained for a period of 10 years (120 months), unless early release is approved by the commissioner of insurance of the insurer's state of domicile.

Significant loss experience during the recent sub-prime mortgage crisis has noted that:

- Contingency reserve historic allocations under the current automatic formula calculation are not driven by economic indicators of potential mortgage crisis and economic downturn, as recently experienced

- Contingency reserve protection provisions can easily be exhausted and depleted under provisions which allow for the early withdrawal when losses exceed 35% of corresponding earned premiums during such periods of economic downturn

Accordingly, Mortgage Guaranty Insurance Model Act amendments emphasize the strengthening of Contingency Reserve provisions through:

1. Contingency reserve increased allocation based on recognition of economic indicators of potential cyclical downturns in the mortgage industry

2. Contingency reserve retention period extension to build-up reserve positions for periods of cyclical downturn in the mortgage industry

3. Contingency reserve additional release restrictions

The Reserves section includes premium deficiency reserve requirements that impact both actuarial opinion and financial statement reporting.

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Section 17 Quality Assurance

Annotation 7: This section is intended to complement the underwriting guidelines discussed under section 10 through the proposed establishment of mortgage guaranty insurer independent internal quality assurance guidelines, which provide a prospective "early warning system" to monitor and identify potential risk, control and compliance weaknesses associated with:

(1) Senior management oversight
(2) Board of director oversight
(3) Loan policy and procedure documentation
(4) Underwriting risk tolerance levels and exposures
(5) Lender underwriting performance
(6) Mortgage guaranty insurer underwriter performance
(7) Problem loan trends
(8) Underwriting system change oversight
(9) Pricing and performance oversight
(10)Internal audit validation

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Section 18 Rescission

Annotation 8: This section addresses the mortgage guaranty insurance industry rescission rights and responsibilities.

The Mortgage Guaranty Insurer's exercise of rescission rights essentially consists of the unwinding of an insurance contract as if the contract was never entered into. Premiums are typically returned by the insurer and no claims are paid. Rescission typically results based on the mortgage guaranty insurer's determination that coverage provided under a policy was essentially not in force due to:

- Misrepresentation
- Failure to follow underwriting guidelines
- Failure to meet certain obligations at the time the policy was written

Rescissions have historically occurred on a loan by loan basis on the back-end, based on review of loan origination documents in conjunction with the normal processing of claims submitted, to evaluate the ability to deny coverage or, at the very least, reduce the claim amount.

Loans entering the rescission process typically resulted from loans originated during the 2005-2007 period coinciding with the housing market peak and the rise in subprime mortgages. Rescission volume increased dramatically, based on increasing MI company evidence of misrepresentation, fraud, loans not meeting bulk commitments and loan overstatement of value.

The exercise of coverage rescissions has materially mitigated paid losses during the subprime mortgage crisis. Business insured by mortgage guaranty insurers over the last 6 years has been significantly impacted by rescission activity based on significant findings resulting from the claims and underwriting review process associated with:

- Lower quality insured business previously written such as low documentation loans
- Improper underwriting standards
- Delegated lender underwriting

Rescission has often resulted in extensive subsequent settlement proceedings and legal delays to establish eventual rescission rights and responsibilities. Policy rescission volume has also impacted the GSE's due to typical efforts to seek restitution through the qualified servicer. The GSE's and mortgage guaranty insurance industry are in the process of working to address mutually agreed upon standard master policy provisions which will clarify these rescission rights and responsibilities.

Accordingly, the Mortgage Guaranty Insurance Model Act amendments have emphasized the following provisions, which provide greater rescission relief and are anticipated to be generally consistent with ongoing GSE regulatory requirements under review and / or reasonable practices aligned with those requirements:

1) Master policy definitions of both insurer and insured rescission rights and responsibilities
2) Rescission relief provisions based on MI underwriting validation, timely payment history and suspected material misrepresentation considerations

The ~~M~~mortgage ~~G~~guaranty ~~I~~insurance ~~I~~industry is required by law to follow the Unfair Insurance Practices Act (the Act) in each state it is licensed in. Within that Act are specific business practices that constitute unfair claim settlement or compromise practices. This section ~~is to make~~includes a specific reference to such Act so as to remind the industry of its responsibilities.

Section ~~20~~19 Standards Manual

Annotation 9:

This section is reserved for NAIC potential subsequent development of a Mortgage Guaranty Insurance Standards Manual, which could supplement and support the current Mortgage Guaranty Insurance Model Law Amendment.

Conceptually, the primary purpose of such a standards manual would most likely relate to providing a format which would impose a potentially less formal process for periodic update versus the Model Act format, which requires a more formal review and approval process dictated by the NAIC governance structure.

All proposed Model Act changes have currently been included in the Mortgage Guaranty Insurance Model Act Amendment based on:

- Mortgage Guarantee Insurance Working Group initial decision favoring Model Act Amendment versus Guidelines
- Mortgage Guarantee Insurance Working Group initial consensus that Model Act carried potentially greater weight
- Consolidation of all changes in a single document source to facilitate ease of reference and understanding in conjunction with the overall Mortgage Guaranty Insurance Working Group review and update process
- Benefits of Mortgage Guaranty Insurance Working Group identification and approval of all final Model Act changes to facilitate analysis and consistent decisions as to potential areas for future Standards Manual consideration

~~The Mortgage Guaranty Insurance Industry is required by law to follow the Unfair Insurance Practices Act (the Act) in each state it is licensed in. Within that Act are specific business practices that constitute unfair claim settlement or compromise practices. This section is to make a specific reference to such Act so as to remind the industry of its responsibilities.~~

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Attachment B

S. 1217: NAIC PROPOSED LEGISLATIVE LANGUAGE

TITLE I—FEDERAL MORTGAGE INSURANCE CORPORATION

SEC. 103. BOARD OF DIRECTORS.

(c) Consultation – The Board of Directors may, in carrying out any duty, responsibility, requirement, or action authorized under this Act, consult with the Federal banking agencies or any individual Federal banking agency~~,~~. Where such duties, responsibilities, requirements, or actions directly or indirectly affect an insurance company, the board shall consult with the domestic state insurance commissioner or similar state official.~~as the Board determines necessary and appropriate.~~

TITLE II—DUTIES, RESPONSIBILITIES, AND STRUCTURE OF THE FMIC
Subtitle B – Oversight of Market Participants

SEC. 211. APPROVAL OF PRIVATE MORTGAGE INSURERS.

(a) Standards for Approval of Private Mortgage Insurers-

(1) IN GENERAL- The Corporation shall develop, adopt, and publish standards for the approval by the Corporation of private mortgage insurers seeking to provide private mortgage insurance on eligible mortgages.

(2) LIMITATION- No standards developed, adopted, or published under subsection (1) shall affect any state law, regulation, or procedure concerning the regulation of the business of insurance.

(~~2~~3) REQUIRED STANDARDS- The standards required under paragraph (1) shall include--

(A) the financial history ~~and condition~~ of the insurer;

~~(B) the adequacy of the insurer's capital structure, including whether the insurer has sufficient capital to cover the first loss insurance obligations it assumes under this Act and that might be incurred in a period of economic stress, including, but not limited to, any period of economic stress that would result in a 30 percent (or greater) national home price decline;~~

(~~C~~B) the general character and fitness of the management of the insurer, including compliance history with Federal and State laws;

~~(D) the risk presented by such insurer to the Mortgage Insurance Fund;~~

(~~E~~C) the adequacy of insurance and fidelity coverage of the insurer;

(~~F~~D) a requirement that the insurer submit audited financial statements to the Director; and

(~~G~~E) any other standard the Corporation determines necessary or appropriate, provided that standard does not conflict with the limitation in subsection 211(a)(2).~~.~~

(b) Application and Approval-

(1) APPLICATION PROCESS- The Corporation shall establish an application process, in such form and manner and requiring such information as the Corporation may require, for the approval of private mortgage insurers under this section.

(2) APPROVAL- The Corporation, in consultation with the domestic state insurance commissioner or similar state official, may approve any application made pursuant to paragraph (1) provided the private mortgage insurer meets the standards adopted under subsection (a).

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of newly approved private mortgage insurers; and

(B) maintain an updated list of approved private mortgage insurers on the website of the Corporation.

(c) Review, Suspension, and Revocation of Approved Status-

(1) IN GENERAL- The Corporation may review the status of any approved private mortgage insurer if the Corporation is notified of or becomes aware of any violation by the insurer of this Act or the rules promulgated pursuant to this Act.

(2) SUSPENSION OR REVOCATION-

(A) CORPORATION AUTHORITY- If the Corporation determines, in a review pursuant to paragraph (1), that an approved private mortgage insurer no longer meets the standards for approval, the Corporation may suspend or revoke the approved status of such insurer.

(B) RULE OF CONSTRUCTION- The suspension or revocation of an approved private mortgage insurer's approved status under this paragraph shall have no effect on the status of any covered security.

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of any approved private mortgage insurers who lost their approved status; and

(B) maintain an updated list of such insurers on the website of the Corporation.

(d) Appeals-

(1) IN GENERAL-

(A) APPEALS OF DENIALS OF APPLICATION- A private mortgage insurer who submits an application under subsection (b)(1) to become an approved private mortgage insurer may appeal a decision of the Corporation denying such application.

(B) APPEALS OF DENIALS OF BENEFITS OR SUSPENSIONS OF PARTICIPATION- An approved private mortgage insurer may appeal a decision of the Corporation suspending or revoking the approved status of such insurer.

(2) FILING OF APPEAL- Any insurer who files an appeal under paragraph (1) shall file the appeal with the Corporation not later than 90 days after the date on which the person receives notice of the decision of the Corporation being appealed.

(3) FINAL DETERMINATION- The Corporation shall make a final determination with respect to an appeal under paragraph (1) not later than 180 days after the date on which the appeal is filed under paragraph (2).

(e) Avoidance of Conflicts of Interest- With respect to any eligible mortgage collateralizing a covered security insured under this Act, an approved private -mortgage insurer may not provide insurance ~~both--~~

~~(1) in satisfaction of the credit enhancement required under section 2(11)(C); and~~

~~(2)~~ to cover the first loss position of private market holders of any~~such~~ covered security.

(f) This section and the rules, regulations, standards, or orders prescribed by it do not divest any state (or instrumentality thereof) of any authority derived from other applicable law.

SEC. 212. APPROVAL OF SERVICERS.

(a) Standards for Approval of Servicers-

(1) IN GENERAL- The Corporation shall develop, adopt, and publish standards for the approval by the Corporation of servicers to administer eligible mortgages, including standards with respect to--

(A) the collection and forwarding of principal and interest payments;

(B) the maintenance of escrow accounts;

(C) the collection and payment of taxes and insurance premiums;

(D) the maintenance of records on eligible mortgages;

(E) the establishment of foreclosure loss mitigation programs that seek to enhance investor value and prevent, to greatest extent possible, the need to trigger any claim on insurance offered by the Corporation pursuant to this title;

(F) the advancement of principal and interest payments to investors in the case of a delinquency by a borrower until such time as the borrower has made all payments in arrears or the property securing the eligible mortgage has been liquidated; and

(G) implementing the terms of any loss mitigation and foreclosure prevention as required by a uniform securitization agreement developed under section 223.

(2) ADDITIONAL REQUIRED STANDARDS- The standards required under paragraph (1) shall also include--

(A) the financial history and condition of the servicer;

(B) the general character and fitness of the management of the servicer, including compliance history with Federal and State laws;

(C) the risk presented by such servicer to the Mortgage Insurance Fund;

(D) a requirement that the servicer submit audited financial statements to the Corporation; and

(E) any other standard the Corporation determines necessary or appropriate.

(3) COORDINATION WITH OTHER REGULATORS- In developing the standards required under paragraph (1), the Corporation shall--

(A) coordinate with the Bureau of Consumer Financial Protection; and

(B) to the extent the Corporation determines practical and appropriate, shall coordinate with the other Federal banking agencies.

(b) Application and Approval-

(1) APPLICATION PROCESS- The Corporation shall establish an application process--

(A) in such form and manner and requiring such information as the Corporation may require, for the approval of servicers under this section; and

(B) that does not discriminate against or otherwise disadvantage small servicers.

(2) APPROVAL- The Corporation may approve any application made pursuant to paragraph (1) provided the servicer meets the standards adopted under subsection (a).

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of newly approved servicers; and

(B) maintain an updated list of approved servicers on the website of the Corporation.

(c) Review, Suspension, and Revocation of Approved Status-

(1) IN GENERAL- The Corporation may review the status of any approved servicer if the Corporation is notified of or becomes aware of any violation by the servicer of this Act or the rules promulgated pursuant to this Act, including any failure by an approved servicer to comply with terms set forth in any uniform securitization agreement developed under section 223.

(2) SUSPENSION OR REVOCATION-

(A) CORPORATION AUTHORITY- If the Corporation determines, in a review pursuant to paragraph (1), that an approved servicer no longer meets the standards for approval, the Corporation may suspend or revoke the approved status of such servicer.

(B) RULE OF CONSTRUCTION- The suspension or revocation of an approved servicer's approved status under this paragraph shall have no effect on the status of any covered security.

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of any approved servicers who lost their approved status; and

(B) maintain an updated list of such servicers on the website of the Corporation.

(d) Appeals-

(1) IN GENERAL-

(A) APPEALS OF DENIALS OF APPLICATION- A servicer who submits an application under subsection (b)(1) to become an approved servicer may appeal a decision of the Corporation denying such application.

(B) APPEALS OF DENIALS OF BENEFITS OR SUSPENSIONS OF PARTICIPATION- An approved servicer may appeal a decision of the Corporation suspending or revoking the approved status of such servicer.

(2) FILING OF APPEAL- Any servicer who files an appeal under paragraph (1) shall file the appeal with the Corporation not later than 90 days after the date on which the person receives notice of the decision of the Corporation being appealed.

(3) FINAL DETERMINATION- The Corporation shall make a final determination with respect to an appeal under paragraph (1) not later than 180 days after the date on which the appeal is filed under paragraph (2).

(e) Petitions for Change of Servicer by Private Market Holders- The Corporation shall develop a process by which private market holders of the first loss position in a covered security may petition the Corporation for a change in approved servicers if the private market holders can demonstrate that their current approved servicer has failed to appropriately protect their investment, including by failing to meet any standard identified under subsection (a)(1).

SEC. 213. APPROVAL OF ISSUERS.

(a) Standards for Approval of Issuers-

(1) IN GENERAL- The Corporation shall develop, adopt, and publish standards for the approval by the Corporation of issuers to issue covered securities, including standards with respect to an issuer's ability to--

(A) aggregate eligible mortgage loans into pools;

(B) securitize eligible mortgage loans for sale to private investors as a covered security;

(C) transfer investment risk and credit to private market participants in accordance with the risk-sharing mechanisms developed by the Corporation under section 202;

(D) ensure equitable access to the secondary mortgage market for covered securities for all institutions regardless of size or geographic location;

(E) create mechanisms for multi-lender pools; and

(F) ensure that eligible mortgage loans that collateralize a covered security insured under this title are originated in compliance with the requirements of this Act.

(2) ADDITIONAL REQUIRED STANDARDS- The standards required under paragraph (1) shall include--

(A) the financial history and condition of the issuer;

(B) the adequacy of the capital structure of the issuer;

(C) the general character and fitness of the management of the issuer, including compliance history with Federal and State laws;

(D) the risk presented by such issuer to the Mortgage Insurance Fund;

(E) the adequacy of insurance and fidelity coverage of the issuer;

(F) a requirement that the issuer submit audited financial statements to the Corporation;

(G) the capacity of the issuer to secure first loss credit enhancement; and

(H) any other standard the Corporation determines necessary or appropriate.

(b) Application and Approval-

(1) APPLICATION PROCESS-

(A) IN GENERAL- The Corporation shall establish an application process, in such form and manner and requiring such information as the Corporation may require, for the approval of issuers under this section.

(B) APPLICATION PROCESS FOR INSURED DEPOSITORY INSTITUTIONS- If an insured depository institution seeks to become an approved issuer under this section, such institution may only submit its application via a separately capitalized affiliate or subsidiary.

(C) APPLICATION PROCESS FOR INSURANCE COMPANIES- If an insurance company seeks to become an approved issuer under this section, the Board shall consult with the domestic state insurance commissioner or similar state official prior to approval of the application.

(2) APPROVAL- The Corporation--

(A) may approve--

(i) any application made pursuant to paragraph (1) provided the issuer meets the standards adopted under subsection (a); and

(ii) any application to become an approved issuer made by the Federal Home Loan Bank System; and

(B) shall ensure that at least one issuer approved to issue covered securities under this section is dedicated to serving the securitization needs of credit unions and community and mid-size banks without securitization capabilities.

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of newly approved issuers; and

(B) maintain an updated list of approved issuers on the website of the Corporation.

(c) Federal Home Loan Bank System-

(1) IN GENERAL- If the Federal Home Loan Bank System is approved by the Corporation to become an approved issuer under this section, the Corporation shall--

(A) develop a process by which each individual Federal Home Loan Bank may elect not to engage or otherwise contribute to any activity practiced by the Federal Home Loan Bank System as an approved issuer;

(B) ensure that, notwithstanding section 11 of the Federal Home Loan Bank Act (12 U.S.C. 1431), any covered securities issued by the Federal Home Loan Bank System as an approved issuer are not issued as consolidated Federal Home Loan Bank debentures and are explicitly designated or otherwise treated as not being the joint and several obligations of any individual Federal Home Loan Bank that has made an election under subparagraph (A); and

(C) ensure that in establishing the capital standards set forth under subsection (a)(2)(B) with respect to the Federal Home Loan Bank System, that such standards shall--

(i) not be applicable to any individual Federal Home Loan Bank that has made an election under subparagraph (A);

(ii) be based on the volume of eligible mortgage loan originations made by the Federal Home Loan Banks that have not made an election under subparagraph (A); and

(iii) not adversely impact the traditional liquidity and advance business of the Federal Home Loan Banks or the Federal Home Loan Bank System.

(2) FEDERAL HOME LOAN BANK ACT-

(A) AMENDMENT- Section 12 of the Federal Home Loan Bank Act (12 U.S.C. 1432) is amended by adding at the end the following:

`(c) Subject to such regulations as may be prescribed by the Corporation, one or more Federal Home Loan Banks may establish a subsidiary. Any subsidiary established under this subsection shall be subject to supervision by the Office of Federal Home Loan Bank Supervision of the Corporation and shall be restricted to engaging in activities related to being an approved issuer, as that term is defined under section 2(2) of the Housing Finance Reform and Taxpayer Protection Act of 2013.'.

(B) EFFECTIVE DATE- The amendment made by subparagraph (A) shall take effect on the transfer date.

(d) Review, Suspension, and Revocation of Approved Status-

(1) IN GENERAL- The Corporation may review the status of any approved issuer if the Corporation is notified of or becomes aware of any violation by the issuer of this Act or the rules promulgated pursuant to this Act.

(2) SUSPENSION OR REVOCATION-

(A) CORPORATION AUTHORITY- If the Corporation determines, in a review pursuant to paragraph (1), that an approved issuer no longer meets the standards for approval, the Corporation may suspend or revoke the approved status of such issuer.

(B) RULE OF CONSTRUCTION- The suspension or revocation of an approved issuer's approved status under this paragraph shall have no effect on the status of any covered security.

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of any approved issuers who lost their approved status; and

(B) maintain an updated list of such issuers on the website of the Corporation.

(e) Appeals-

(1) IN GENERAL-

(A) APPEALS OF DENIALS OF APPLICATION- An issuer who submits an application under subsection (b)(1) to become an approved issuer may appeal a decision of the Corporation denying such application.

(B) APPEALS OF DENIALS OF BENEFITS OR SUSPENSIONS OF PARTICIPATION- An approved issuer may appeal a decision of the Corporation suspending or revoking the approved status of such issuer.

(2) FILING OF APPEAL- Any issuer who files an appeal under paragraph (1) shall file the appeal with the Corporation not later than 90 days after the date on

which the person receives notice of the decision of the Corporation being appealed.

(3) FINAL DETERMINATION- The Corporation shall make a final determination with respect to an appeal under paragraph (1) not later than 180 days after the date on which the appeal is filed under paragraph (2).

(f) Limitation on Market Share-

(1) IN GENERAL- The Corporation may not enter into any contract, covenant, or other agreement with an approved issuer, if such contract, covenant, or agreement would provide the issuer a share of the covered security issuer market in excess of 15 percent of the total market, as such market is measured by the total outstanding principal balance at origination of eligible mortgages collateralizing covered securities issued in the previous 12-month period.

(2) EXCEPTION- The limitation set forth under paragraph (1) shall not apply to--

(A) an approved issuer described under subsection (b)(2)(A)(ii);

(B) the FMIC Mutual Securitization Company;

(C) any approved issuer which securitizes only eligible mortgage loans originated by the issuer or an affiliate of the issuer; or

(D) any approved issuer to which the Corporation grants a waiver pursuant to paragraph (3).

(3) WAIVER- The Corporation may, during the 3-year period beginning on the FMIC certification date, grant a waiver from the limitation set forth under paragraph (1) to an approved issuer if the Corporation determines that the number of approved issuers is insufficient, such that imposition of the limitation would adversely affect the availability of mortgage credit.

(g) Limited Authority To Hold Eligible Mortgage Loans- An approved issuer may, for a period not to exceed 6-months, hold--

(1) eligible mortgage loans on the balance sheet of such issuer; and

(2) the first loss position in a covered security for purposes of obtaining insurance under this title.

(h) This section and the rules, regulations, standards, or orders prescribed by it do not divest any state (or instrumentality thereof) of any authority derived from other applicable law.

SEC. 214. APPROVAL OF BOND GUARANTORS.

(a) Standards for Approval of Bond Guarantors-

(1) IN GENERAL- The Corporation shall develop, adopt, and publish standards for the approval by the Corporation of bond guarantors to guarantee the timely payment of principal and interest on securities collateralized by eligible mortgages and insured by the Corporation.

(2) LIMITATION- No standards developed, adopted, or published under subsection (1) shall affect any state law, regulation, or procedure concerning the regulation of the business of insurance.

(3) INSURANCE COMPANIES- If an insurance company seeks to become an approved bond guarantor under this section, it must be licensed and in good standing with each state for which it is covering mortgages collateralizing the bonds that it guarantees.

(~~2~~4) REQUIRED STANDARDS- Subject to the limitation in paragraph (2), ~~T~~the standards required under paragraph (1) shall include--

(A) the financial history and condition of the guarantor;

(B) that the guarantor maintain a minimum capital level equal to not less than 10 percent of the unpaid principal balance of outstanding mortgage-backed securities for which the guarantor is providing insurance, net of any transactions, including derivative transactions, repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions, that in the determination of the Corporation are used by the guarantor to hedge or mitigate against credit risk, provided that any such hedging transaction does not diminish the total amount of loss absorption capital in the secondary mortgage market that stands in front of the insurance provided by the Corporation under this title;

(C) the general character and fitness of the management of the guarantor, including compliance history with Federal and State laws;

(D) the risk presented by such guarantor to the Mortgage Insurance Fund;

(E) the adequacy of insurance and fidelity coverage of the guarantor;

(F) a requirement that the guarantor submit audited financial statements to the Director;

(G) a requirement that the guarantor meet a minimum tangible common equity level, or other minimum capital threshold as the Corporation determines necessary; and

(H) any other standard the Corporation determines necessary or appropriate, provided such standard does not conflict with subsection 214(a)(2).

(b) Rule of Construction- Any covered security issued by an approved issuer and insured by an approved bond guarantor shall be deemed to have satisfied the credit-risk sharing requirements under section 202(a)(1) with respect to the eligibility of that security to obtain insurance under this title.

(c) Application and Approval-

(1) APPLICATION PROCESS-

(A) IN GENERAL- The Corporation shall establish an application process, in such form and manner and requiring such information as the Corporation may require, for the approval of bond guarantors under this section.

(B) APPLICATION PROCESS BY INSURED DEPOSITORY INSTITUTIONS- If an insured depository institution seeks to become an approved bond guarantor under this section, such institution may only submit its application via a separately capitalized affiliate or subsidiary.

(C) APPLICATION PROCESS FOR INSURANCE COMPANIES- If an insurance company seeks to become an approved bond guarantor under this section, the Board shall consult with the domestic state insurance commissioner or similar state official prior to approval of the application.

(2) APPROVAL- The Corporation may approve any application made pursuant to paragraph (1) provided the bond guarantor meets the standards adopted under subsection (a).

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of newly approved bond guarantors; and

(B) maintain an updated list of approved bond guarantors on the website of the Corporation.

(d) Review, Suspension, and Revocation of Approved Status-

(1) IN GENERAL- The Corporation may review the status of any approved bond guarantor if the Corporation is notified of or becomes aware of any violation by the insurer of this Act or the rules promulgated pursuant to this Act.

(2) SUSPENSION OR REVOCATION-

(A) CORPORATION AUTHORITY- If the Corporation determines, in a review pursuant to paragraph (1), that an approved bond guarantor no longer meets the standards for approval, the Corporation shall revoke the approved status of such guarantor.

(B) RULE OF CONSTRUCTION- The revocation of an approved bond guarantor's approved status under this paragraph shall have no effect on the status of any covered security.

(3) PUBLICATION- The Corporation shall--

(A) publish in the Federal Register a list of any approved bond guarantors who lost their approved status; and

(B) maintain an updated list of such guarantors on the website of the Corporation.

(e) Appeals-

(1) IN GENERAL-

(A) APPEALS OF DENIALS OF APPLICATION- A bond guarantor who submits an application under subsection (c)(1) to become an approved bond guarantor may appeal a decision of the Corporation denying such application.

(B) APPEALS OF DENIALS OF BENEFITS OR SUSPENSIONS OF PARTICIPATION- An approved bond guarantor may appeal a decision of the Corporation suspending or revoking the approved status of such guarantor.

(2) FILING OF APPEAL- Any bond guarantor who files an appeal under paragraph (1) shall file the appeal with the Corporation not later than 90 days after the date on which the person receives notice of the decision of the Corporation being appealed.

(3) FINAL DETERMINATION- The Corporation shall make a final determination with respect to an appeal under paragraph (1) not later than 180 days after the date on which the appeal is filed under paragraph (2).

(f) Limitations on Approved Bond Guarantors- With respect to any eligible mortgage collateralizing a covered security insured under this Act, an approved bond guarantor may not provide insurance--

(1) in satisfaction of the credit enhancement required under section 2(11)(C) or as an approved private mortgage insurer pursuant to section 211; and

(2) as an approved bond guarantor under this section.

(g) Permission To Carry Out Other Activities- Nothing in this Act prohibits an approved bond guarantor from being or controlling an approved issuer, provided that each issuer and bond guarantor, independent of each other, meet the approval standards established by the Corporation under this title.

(h) This section and the rules, regulations, standards, or orders prescribed by it do not divest any state (or instrumentality thereof) of any authority derived from other applicable law.

SEC. 215. AUTHORITY TO ESTABLISH FMIC MUTUAL SECURITIZATION COMPANY.

(a) In General- The Corporation shall establish a mutual corporation to be known as the 'FMIC Mutual Securitization Company'.

(b) Purpose- The purpose of the FMIC Mutual Securitization Company is to--

(1) develop, securitize, sell, and otherwise meet the issuing needs of credit unions, community and mid-size banks, and non-depository mortgage originators with respect to covered securities; and

(2) purchase from its member participants for cash, on a single loan basis, eligible mortgage loans to securitize in a covered security.

(c) Sale of Necessary Technology- Upon the FMIC certification date, the enterprises shall sell to the FMIC Mutual Securitization Company any function, activity, infrastructure, property, including intellectual property, platform, or any other object or service of an enterprise that the Corporation determines necessary for the FMIC Mutual Securitization Company to carry out its activities and operations.

(d) Designation as an Approved Issuer- The FMIC Mutual Securitization Company shall be an approved issuer for purposes of section 213.

(e) Eligibility- Eligibility to participate as a member in the FMIC Mutual Securitization Company shall be limited to--

(1) insured depository institutions having less than $15,000,000,000 in total consolidated assets at the time of the institution's initial participation in the Company; or

(2) any non-depository mortgage originator having a minimum net worth of $2,500,000.

(f) Governance-

(1) RECOGNITION OF IMPORTANT ROLE OF SMALLER INSTITUTIONS- The Corporation shall take all necessary steps to ensure that the governance provisions of the FMIC Mutual Securitization Company reflect the important role in the mortgage market played by the small and mid-sized member participants of the FMIC Mutual Securitization Company.

(2) ESTABLISHMENT OF POSITION OF DIRECTOR- There is established the position of the Director of the FMIC Mutual Securitization Company who shall be the head of the Company.

(3) BOARD OF DIRECTORS-

(A) IN GENERAL- The management of the FMIC Mutual Securitization Company shall be vested in a Board of Directors (hereafter referred to as the `Mutual Board'), which shall include representatives of member participants of the Company, including representatives of--

(i) mortgage bankers;

(ii) community banks; and

(iii) credit unions.

(B) INITIAL APPOINTMENT- The Corporation shall make initial appointments of the members of the Mutual Board. Each such initial appointment shall be for a term 1 year.

(C) APPOINTMENTS- Following the initial 1-year appointment of the members of the Mutual Board, member participants in the FMIC Mutual Securitization Company shall elect the members of the Mutual Board from within the membership of the Company.

(D) ADMINISTRATION- The Mutual Board shall administer the affairs of the FMIC Mutual Securitization Company fairly and impartially and without discrimination.

(4) NO PREFERENCES FOR SIZE- Member participants of the FMIC Mutual Securitization Company shall have equal voting rights on any matters before the Company, regardless of the size of the individual member participant.

(g) Approval of Member Participants-

(1) IN GENERAL- The Mutual Board shall develop standards and procedures to approve the application of member participants in the FMIC Mutual Securitization Company.

(2) CONTENT OF STANDARDS- The standards required under paragraph (1) shall include standards relating to the safety and soundness of prospective member participants, including standards regarding the underwriting practices of such prospective members.

(3) COORDINATION WITH OTHER REGULATORS-

(A) CONSULTATION- In approving any prospective member to become a member participant in the FMIC Mutual Securitization Company, the Mutual Board may consult and share information with the primary prudential regulator of the prospective member.
(B) PRIVILEGE PRESERVED- Information shared pursuant to subparagraph (A) shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that a prospective member may claim with respect to such information under Federal or State law as to any person or entity other than the Mutual Board or its primary prudential regulator.
(C) RULE OF CONSTRUCTION- No provision of this subsection may be construed as implying or establishing that--
(i) any prospective member waives any privilege applicable to information that is shared or transferred under any circumstance to which this subsection does not apply; or
(ii) any prospective would waive any privilege applicable to any information by submitting the information directly to its primary prudential regulator, but for this subsection.

(h) Funding Authority-
(1) AUTHORITY TO ESTABLISH MEMBERSHIP FEES- The Mutual Board shall have the authority to charge and collect fees, and may in its discretion increase or decrease such fee, on its member participants for membership in the FMIC Mutual Securitization Company, including to cover the costs of--
(A) the initial capitalization of the Company;
(B) the purchase of any function, activity, infrastructure, property, including intellectual property, platform, or any other object or service from an enterprise pursuant to subsection (c); and
(C) the continued operation of the Company.
(2) LIMITATION- The fees authorized under paragraph (1)--
(A) shall be equitably assessed; and
(B) may be based on the volume of eligible mortgages that the member participant sells to the FMIC Mutual Securitization Company.

(i) Coordination of Servicer Approval- The Mutual Board may coordinate with the Corporation to facilitate the application process for its member participants to become approved servicers of the Corporation pursuant to section 212.

SEC. 216. ADDITIONAL AUTHORITY RELATING TO OVERSIGHT OF MARKET PARTICIPANTS.

(a) In carrying out its authorities under this subtitle, the Corporation may, in its discretion, develop, publish, and adopt such other additional standards or requirements as the Corporation determines necessary to ensure--
(1) competition among approved private mortgage insurers, servicers, issuers, and bond guarantors and other market participants in the secondary mortgage market;

(2) competitive pricing among approved private mortgage insurers, servicers, issuers, and bond guarantors and other market participants in the secondary mortgage market; and
(3) liquidity, transparency, and access to mortgage credit in the secondary mortgage market.

(b) LIMITATION- No standards or requirements developed, published, or adopted under subsection (a) shall affect any state law, regulation, or procedure concerning the regulation of the business of insurance.

SEC. 217. CIVIL MONEY PENALTIES.

(a) Authority- In addition to any suspension or revocation of the approved status of an approved private mortgage insurer, servicer, issuer, or bond guarantor under this subtitle, the Corporation may, in its discretion, impose a civil money penalty on any such approved private mortgage insurer, servicer, issuer, or bond guarantor that has failed to comply with or otherwise violates--
(1) any standard adopted by the Corporation pursuant to this subtitle; or
(2) any other requirement or provision of this Act, or any order, condition, rule, or regulation issued pursuant to this Act, applicable to such private mortgage insurer, servicer, issuer, or bond guarantor, as the case may be.
(b) Procedures-
(1) ESTABLISHMENT- The Corporation shall establish standards and procedures governing the imposition of civil money penalties under this section. Such standards and procedures--
(A) shall provide for the Corporation to notify the approved private mortgage insurer, servicer, issuer, or bond guarantor, as the case may be, in writing of the determination of the Corporation to impose the penalty, which shall be made on the record;
(B) shall provide for the imposition of a penalty only after the approved private mortgage insurer, servicer, issuer, or bond guarantor, as the case may be, has been given an opportunity for a hearing on the record; and
(C) may provide for review by the Corporation of any determination or order, or interlocutory ruling, arising from a hearing.
(2) FACTORS DETERMINING AMOUNT OF PENALTY- In determining the amount of a penalty under this section, the Corporation shall give consideration to factors including--
(A) the gravity of the offense;
(B) any history of prior offenses;
(C) ability to pay the penalty;
(D) injury to the public;
(E) benefits received;
(F) deterrence of future violations; and
(G) such other factors as the Corporation may determine, by regulation, to be appropriate.

(c) Action To Collect Penalty- If the approved private mortgage insurer, servicer, issuer, or bond guarantor, as the case may be, fails to comply with an order by the Corporation imposing a civil money penalty under this section, the Corporation may bring an action in the United States District Court for the District of Columbia to obtain a monetary judgment against the approved private mortgage insurer, servicer, issuer, or bond guarantor, as the case may be, and such other relief as may be available. The monetary judgment may, in the court's discretion, include the attorneys' fees and other expenses incurred by the United States in connection with the action. In an action under this subsection, the validity and appropriateness of the order imposing the penalty shall not be subject to review.
(d) Settlements- The Corporation may compromise, modify, or remit any civil money penalty which may be, or has been, imposed under this section.
(e) Deposit of Penalties- The Corporation shall use any civil money penalties collected under this section to help fund the Mortgage Insurance Fund established under section 203.

SEC. 218. PROTECTION OF PRIVILEGE AND OTHER MATTERS RELATING TO DISCLOSURES BY MARKET PARTICIPANTS.

(a) Information Sharing and Maintenance of Privilege- The Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.) is amended--

(1) in section 11(t)(2)(A) (12 U.S.C. 1821(t)(2)(A)), by inserting after clause (v) the following:

`(vii) The Federal Mortgage Insurance Corporation.'; and

(2) in section 18(x) (12 U.S.C. 1828(x))--

(A) by inserting `the Federal Mortgage Insurance Corporation,' before `any Federal banking agency' each place that term appears; and

(B) by striking `such agency' each place that term appears and inserting `Corporation, agency'.

(b) Permissible Consultation With ~~Federal Banking~~ Regulatory Agencies-

(1) IN GENERAL- Pursuant to its authority under section 103(c), to facilitate the consultative process, the Corporation may share information with the Federal banking agencies, or any individual Federal banking agency, or any state insurance commissioner or similar state official, or any State bank supervisor, or foreign banking authority, on a one-time, regular, or periodic basis as determined by the Corporation regarding the capital, asset and liabilities, financial condition, risk management practices or any other practice of any approved private mortgage insurer, servicer, issuer, or bond guarantor.

(2) PRIVILEGE PRESERVED- Information shared by the Corporation pursuant to paragraph (1) shall not be construed as waiving, destroying, or otherwise affecting any privilege or confidential status that any approved private mortgage insurer, servicer, issuer, or bond guarantor or any other person may claim with respect to such information under Federal or State law as to any person or entity other than such agencies, agency, supervisor, or authority.

(3) RULE OF CONSTRUCTION- No provision of this subsection may be construed as implying or establishing that--

(A) any person waives any privilege applicable to information that is shared or transferred under any circumstance to which this subsection does not apply; or
(B) any person would waive any privilege applicable to any information by submitting the information directly to the Federal banking agencies, or any individual Federal banking agency, or any State bank supervisor, or foreign banking authority, but for this subsection.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COBURN FROM KURT REGNER

Q.1. Would you agree S.1217 proposes to give the future Federal Mortgage Insurance Corporation approval and oversight authority over private mortgage insurers and bond guarantors?

A.1. The GSE's are currently the largest purchasers of mortgages on the secondary market, so it seems the provisions set out within S.1217 give FMIC de facto, if not explicit approval and oversight authority over private mortgage insurers and bond guarantors. In my view this is not necessary, given the extensive oversight already performed by State insurance regulators.

Q.2. Would you agree States already have the necessary tools and authority to regulate private mortgage insurers and bond guarantors to the level necessary to maintain a stable housing-finance system?

A.2. Yes, States already have the necessary tools and authority to regulate private-mortgage insurers and bond guarantors to the level necessary to maintain a stable housing finance system. Moreover, when area for improvement is identified, States act collectively together to development enhancements. Such is the case today—State regulators are in the process of considering targeted revisions to the NAIC's Mortgage Guaranty Insurance Model Act (#630-11) through the open and transparent NAIC process.

In 2011, the NAIC Financial Guaranty Insurance Guideline (E) Working Group considered the need to change the regulation of Financial Guarantors and the NAIC Financial Guaranty Model Act. The Working Group concluded that because Financial Guaranty Insurers were at the time, and are still today only actively writing municipal bond insurance and no company is writing guarantees on structured bonds following the losses incurred during the financial crisis, there was no need to amend the regulation of the Model Act at that time.

Q.3. Please describe the current activities of State insurance commissioners to strengthen the capital requirements and other operating procedures of private mortgage insurers and bond guarantors to bolster the housing finance system.

A.3. State insurance regulators are actively studying what changes are deemed necessary to the solvency regulation of mortgage guaranty insurers. The NAIC's Mortgage Guaranty Insurance (E) Working Group was formed by the Financial Condition (E) Committee in late 2012. This Working Group is assessing what changes should be made to the Model Act.

In February 2013, the Working Group identified three primary problems with mortgage guaranty insurance as it exists now:

1. The overconcentration of mortgage originations in only a few banks has increased the pressure on mortgage insurers to accept everything given to them by any single bank or risk losing all the business from that bank.
2. The 2008 crisis dramatically illustrated the cyclical nature of the housing market and the potential for significant losses if there is a breakdown in mortgage underwriting standards. Mortgage insurance is derivative of this market, and therefore

experiences periods of relative stability and high profitability potentially followed by periods of varying duration of significant loss.

3. The lack of incentives to continue adhering to strict underwriting standards during booming periods when there is no threat of discontinued business.

In order to address these problems, the Working Group is considering a number of potential changes:

- New reporting requirements that break out mortgage insurers' exposures to different levels of risk and are used as partial input into the minimum capital requirements.
- Prohibition of captive reinsurance agreements between mortgage insurers and originating banks.
- Referring potential accounting issues to the NAIC's Statutory Accounting Principles (E) Working Group.
- A Risked Based Capital formula specific to Mortgage Insurers.
- Updating the geographical concentration levels.
- Reevaluating underwriting loan standards.
- Tighter dividend restrictions.
- Reevaluating rescission practices and responsibilities.

The Working Group exposed a concept draft of a new model (Attachment A) for public comment and debate, and the comment period closed February 17, 2014. We expect the NAIC to pass the amendments to the model later this year, and States to begin implementing the amendments soon thereafter.

Where bond guarantors are concerned, at this time, there are no initiatives by the State insurance commissioners to change regulations, because bond guarantors are not actively involved in guaranteeing structured bonds, including residential mortgage-backed securities.

Q.4. Please describe how new Federal oversight functions included in S.1217 would duplicate and potentially preempt the regulations from State insurance commissioners.

A.4. S.1217 presents a number of potential duplication concerns for State regulators.

First, there is the notion of an "approval" process by the new FMIC. There is already an approval process in place for private mortgage insurers to do business—it occurs at the State insurance departments, when we approve a license. It is our job as regulators to monitor the insurer's solvency through capital requirements, reserve requirements, coverage, investment, and geographic concentration limits, and limitations on nonmortgage activities. There is no need for FMIC to duplicate the efforts of effective State regulation. Instead of duplicating, S.1217 should defer to the licensing and other standards that are required by State laws in order to write or provide mortgage guaranty or bond insurance coverage, just as bank regulators defer to State insurance regulators on the oversight of homeowners insurers who, in the event of a loss, are relied upon by lenders to be made whole or protected.

Second, State insurance regulators carefully balance solvency concerns with availability of coverage to ensure a competitive marketplace. Experience has shown us that the incentive is simply too great for a regulator charged with maintaining the viability of a Government guarantee, such as the FMIC, to overshoot its regulatory objective and put in place standards, particularly solvency standards such as capital requirements, that are more stringent than necessary. This would ultimately threaten the availability of coverage, increase cost to the policyholder and undermine the objective of a private market solution to support a vibrant housing market for the future.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM BART DZIVI

Q.1. S.1217 proposes the regulator have, with the consent of other officials, emergency powers in a crisis that only lasts 6 months. Should we consider expanding that authority, or providing other countercyclical tools that a regulator may need in a future crisis?

A.1. Section 205 of the legislation provides that during exigent circumstances, the Corporation, for a period not to exceed 6 months, may continue to sell insurance for covered securities regardless of whether the security satisfies the first loss position for private market holders and other potential requirements developed under Section 202(a) of the legislation.

Providing policy makers with adequate and timely statutory tools is critical to allow them to address issues prior to a crisis erupting. If policy makers have to wait for Congress to respond, the resulting financial shock, and the depth of the crisis, will be much more severe. As the recent financial crisis has demonstrated, when a severe financial crisis strikes the United States again, it is not likely to abate within six (6) months. One of the primary responses to the recent financial crisis by the Board of Governors of the Federal Reserve System (Federal Reserve) has been the purchase of mortgage backed securities (MBS) issued by Fannie Mae and Freddie Mac. On November 25, 2008, the Federal Reserve announced it would undertake the purchase of $500 billion of agency MBS. On February 27, 2014, Federal Reserve Chair Yellen testified that the Federal Reserve expects to end its agency MBS purchases this year. Thus, the Federal Reserve's policy response has been to purchase agency MBS for over five (5) years. In that context, statutory authority to provide extraordinary issuance of insurance to back MBS for only six (6) months, and only after an emergency has been declared by the Federal Reserve Chair and the Secretary of Treasury, seems wholly insufficient to stabilize the economy.

While the debt markets for private corporations seized up, and essentially halted, during the most extreme moments of the financial crisis, the Government Sponsored Entities (GSEs) and the Federal Home Loan Banks (FHLBs) were able to issue debt to fulfill their functions. They were only able to do so because the markets perceived that the United States Government stood behind that debt. This is the most important countercyclical weapon in the arsenal that Federal policy makers have to fight a financial crisis. Congress can best equip the country to withstand future financial shocks by keeping the FHLBs, and the replacements for the GSEs, financially strong and independent, so that they can issue unsecured debt that the markets will accept, and that the Government can stand behind without incurring losses, during future panics.

I concur with that part of the analysis in the paper published by the Center for Responsible Lending, "A Framework for Housing Reform: Fixing What Went Wrong and Building on What Works", (Oct. 28, 2013) that suggests that the replacements for the GSEs (for MBS issuer guarantees) should be mutually owned cooperatives (not investor owned companies and not a Government corporation), and notes that we know this system can work because Freddie Mac was a cooperative within the Federal Home Loan Bank system when it was founded in 1970. Creating a strong mutual cooperative is the best countercyclical tool. See also, "The Capital Structure and Governance of a Mortgage Securitization Utility", Federal Reserve Bank of New York, Staff Report No. 644 (Oct. 2013).

Q.2. What can we put in statute to ensure that the FHLBs receive sufficient attention and oversight in a new system, given the differences between the FHLBs and the replacements for the GSEs?

A.2. The Federal Housing Finance Board (FHFB) was the predecessor-in-interest to the Federal Housing Finance Agency (the "FHFA" was created in 2008) with respect to the prudential supervision and regulation of the Federal Home Loan Banks; the Office of Federal Housing Enterprise Oversight (OFHEO) was the predecessor-in-interest to the FHFA with respect to the prudential supervision and regulation of Fannie Mae and Freddie Mac.

The historical results are clear, the FHFB largely succeeded in its mission, and OFHEO largely failed in its mission. The results are due to several factors:

- The Federal Home Loan Banks are operated as mutual cooperatives, with an incentive to constrain risk through conservative lending and investment policies; whereas, Fannie Mae and Freddie Mac were investor owned enterprises where senior managers had stock options and other asymmetric financial incentives that emboldened them to take outsized risk on very small capital bases; and
- The FHFB had strong supervisory powers; whereas OFHEO had been hobbled by Congress with very limited statutory supervisory and enforcement powers.

In 2008, Congress reversed its prior error with OFHEO when it created the FHFA and granted it even stronger supervision and enforcement tools than the FHFB possessed. Congress needs to keep a strong, independent, prudential regulator of both the FHLBs and the replacement for the GSEs. There is no basis in the historical record for eliminating the FHFA. I urge Congress to retain the FHFA as the safety and soundness prudential regulator of both the FHLBs and the replacement for the GSEs.

In order to ensure adequate attention and supervision by the Federal regulatory agency for both the FHLBs and the replacement for the GSEs, I support the structure currently in law of having a dedicated deputy director for each type of entity. In addition, I encourage Congress to adopt a statutory requirement that both the head of the agency, and the deputy director for the relevant entity, appear once a year and testify before Congress to report on the safety and soundness of the FHLBs, and once a year, at a separate time, to report on the safety and soundness of the replacement for the GSEs.

Q.3. S.1217 gives the new regulator many responsibilities. What are the advantages and disadvantages of a structure where a single regulator oversees many type of companies, the insurance fund, the common securitization platform, and other functions?

A.3. It would be a significant mistake if Congress created an entity that could grant insurance on privately issued mortgage backed securities, where the insurance had an explicit Federal guarantee, and the entity that issued the insurance was not supervised and regulated by a separate, independent Federal agency.

Some proponents of S.1217 have argued that the Federal Deposit Insurance Corporation (FDIC) insures deposits at banks, and it is an example of how a Government corporation can do these many type of tasks at once. Setting up an entity to grant insurance on securities, without a separate regulator, creates a significant risk of loss for the Government as guarantor. The argument being made that the FDIC is an example of how a Government corporation can undertake these many tasks without serious problems is deeply flawed and understates the prospects for substantial future losses for the following reasons:

- All FDIC insured banks are subject to separate safety and soundness supervision by their chartering entity (the OCC or State agency) that is designed to avoid insolvency of the bank;
- The FDIC as receiver has access to all the assets of the failed institution to satisfy its claims; an issuer of a mortgage backed security is issuing a stand-alone security that is not backed by any assets of the issuing entity and only by the mortgage loans in the pool specific to that security, and perhaps private mortgage insurance;
- The FDIC as receiver has extraordinary powers designed by Congress to maximize its ability to minimize its losses in a receivership proceeding that it controls; trying to collect from a busted mortgage-backed security, an insolvent private mortgage insurer that had provided a guarantee on the MBS, or an insolvent seller of loans into the pool would involve cumbersome and costly litigation by the Corporation resulting in small recoveries for the Government; and
- Notwithstanding the advantages of the FDIC described above, the FDIC deposit insurance fund went negative during the recent crisis, the prior deposit insurance fund operated by the Federal Savings and Loan Insurance Corporation went insolvent during the 1990s, and various State and private deposit insurance funds have gone broke during other financial crisis.

Having one entity performing many Federal functions, some of which conflict with each other, can be a recipe for disaster. One of the reasons that the Savings and Loan Crisis of the 1980s and early 1990s grew to such a large size was that one entity, the Federal Home Loan Bank Board (FHLBB), was responsible for chartering Federal savings and loans, insuring all savings and loans deposits through the Federal Savings and Loan Insurance Corporation (FSLIC), and effectively running the Federal Home Loan Banks by appointing directors and setting operational rules for the FHLBs. The FHLBB was placed in a position of a conflict-of-interest by Congress, and it used its powers as head of the FHLBs to order the FHLBs to make loans to weak savings and loans to prop them up so the FSLIC could hide the extent of its true losses. The multiple functions envisioned for the Corporation under S.1217 create the same type of conflict of interest. Congress should avoid creating another inherently conflicted entity.

Instead, the legislation should create a privately capitalized mutual company to operate a securitization platform because neither the insurance of securities nor the issuance of securities is a core competence of a Government agency. A separate Federal agency should be established and charged by Congress with issuing rules, and supervising the enforcement of those rules, to keep the entity issuing the guarantee solvent, and to keep the market functioning properly by requiring adequate transparency of the functions performed by the trustees and other participants in mortgage market.

Q.4. As it relates to the regulatory structure of a new housing finance system, what are the most important changes that need to be made to S.1217 to ensure a strong, effective regulator?

A.4. To ensure a strong, effective regulator the legislation should:

- Establish an independent agency as a safety and soundness regulator, completely separate from any other Federal entity, and completely separate from the entity issuing the insurance that provides the Federal guarantee on the mortgage backed security;
- Provide the regulatory agency with strong enforcement and supervision tools equivalent to the tools available to the Federal banking agencies, and with the same independent litigation authority as the Federal banking agencies;
- Grant the regulatory agency independent assessment authority, and the ability to set its own budget without further action by Congress or any other executive branch agency;
- Provide the regulatory agency with the same flexibility to set the level of compensation for its employees as is provided for the Federal banking agencies;
- Require fixed terms for the head of the regulatory agency (or the members of the board at the head of the agency), subject to removal by the President of the United States only for cause (and if there is a board, its members should have staggered terms); and
- Mandate that the regulatory agency have an independent Inspector General with a budget set by Congressional appropriation, not the agency.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM ROBERT M. COUCH

Q.1. S.1217 proposes the regulator have, with the consent of other officials, emergency powers in a crisis that only lasts 6 months.

Should we consider expanding that authority, or providing other countercyclical tools that a regulator may need in a future crisis?

A.1. Any new housing finance system must be resilient enough to weather the inevitable periods when the housing market takes a downward turn. Even during these countercyclical periods, it is critical for the housing finance system to continue to serve as a reliable source of mortgage liquidity.

For most of these periods, the limited Government guarantee for catastrophic risk assumed by the FMIC should help provide for the continued availability of mortgage credit because the Government wrap will assure investors in mortgage-backed securities (MBS) that the MBS will be repaid and the Government will stand behind the credit risk. If credit-risk protection is no longer available through bond guarantors (as envisioned by S.1217) and other private credit enhancers, or if the price of such credit-risk coverage is too high, the Congress could adjust the loan levels for the insurance programs of the Federal Housing Administration (FHA) and U.S. Department of Veterans Affairs (VA), thus allowing the two institutions to expand their activities as they did during the recent crisis.

The BPC Housing Commission also proposed that its Government guarantor (similar to the FMIC) be given the authority to price and absorb first-loss credit risk for limited periods during times of severe economic stress in order to ensure the continued flow of mortgage credit. Under these circumstances, the guarantor would be required to notify the Treasury Department, the Federal Reserve, and the chairs of the appropriate congressional committees before taking any such action. S.1217 provides the FMIC with similar authority, but this authority is subject to a number of more stringent conditions. In addition to the 6-month limitation you cite, these conditions include first obtaining the prior written consent of both the Chairman of the Federal Reserve Board and the Treasury Secretary and a prohibition on using the authority more than once in any given 3-year period.

As I stated in my testimony to the Committee, you may wish to consider empowering the FMIC with more flexibility to ensure it can respond quickly to emergency conditions in the mortgage market. The Committee may also wish to reconsider whether it is appropriate to impose specific time limitations on the FMIC's ability to exercise its emergency authority. It was the Housing Commission's view that prenotification to Congress was a critical part of the decision to use emergency powers. We also concluded that such notification and ongoing Congressional oversight were sufficient to protect against the abuse or excessive use of this authority.

Under the Housing Commission's proposal, neither the Government guarantor, FHA, VA, nor Ginnie Mae would be permitted to have retained portfolios. Similarly, as proposed in S.1217, the FMIC would not have a retained portfolio other than to assist in the orderly wind down of Fannie Mae and Freddie Mac.

The absence of retained portfolios raises concerns about the availability and liquidity of mortgage credit during downturns when demand for MBS or the liquidity with which to purchase these securities could fall precipitously, as occurred in 2008 to

2009. Therefore, Federal policy should be clear on how mortgage liquidity would be managed in such circumstances.

One alternative is through monetary policy and Federal Reserve actions in the market. Such policies should be established in advance of any crisis and should be understood by all market participants in order to forestall any issues that could unnecessarily raise the cost of housing and home ownership. By way of reference, during the 45-year history of Ginnie Mae in which it had no retained portfolio, the presence of a "full faith and credit" guarantee as well as Federal Reserve and Treasury purchasing authority have preserved ample liquidity in Ginnie Mae bonds through numerous credit crises, including the most recent one.

Q.2. How does the source of a regulator's funding affect its oversight capabilities?

A.2. The Government guarantor proposed by the Housing Commission is similar to the FMIC in that both are self-supporting institutions that do not rely on Federal appropriations but rather finance their catastrophic risk funds and operational expenses through the collection of guarantee fees. While the primary purpose here is to protect the taxpayers from unnecessary risk, operating largely outside the Federal appropriations process also gives the institutions some insulation from undue political interference in oversight decisions. The Housing Commission concluded that having this independence would allow the guarantor to respond more quickly to contingencies in the market and operate with greater efficiency in making decisions related to staffing, budgeting, procurement, and policy.

Some may argue that an exclusive reliance on private sources to fund its operations raises the prospect that the FMIC might be "captured" by those entities it regulates. S.1217's creation of an Office of Inspector General within FMIC, charged with assessing the adequacy of the first-loss position held by private institutions as well as providing annual reports on the adequacy of the guarantee fees charged by the FMIC, is an important safeguard against this possibility. Ongoing Congressional oversight is also critical. The successful track record of the Federal Deposit Insurance Corporation (FDIC), an independent Federal agency that does not rely on Federal appropriations but instead is largely funded by the insurance premiums it charges to banks and thrift institutions, demonstrates that the FMIC can be self-supporting and still function effectively.

S.1217 requires the Mortgage Insurance Fund (MIF) to reach a reserve level of 1.25 percent of the guaranteed MBS within 5 years and 2.50 percent within 10 years. By contrast, the FDIC has designated a reserve ratio of 2 percent. To help capitalize the MIF in the early stages of the new system as well as signal the Federal Government's strong commitment to standing up this system, the profits of Fannie Mae and Freddie Mac could be tapped as an initial source of MIF funding.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM PAUL LEONARD

Q.1. S.1217 proposes the regulator have, with the consent of other officials, emergency powers in a crisis that only lasts 6 months. Should we consider expanding that authority, or providing other countercyclical tools that a regulator may need in a future crisis?

A.1. The Housing Policy Council agrees that the Federal regulator should retain some flexibility to adjust prudential standards during periods of severe economic downturns. That authority, if exercised, can reduce economic problems by helping to maintain a flow of housing finance. Since the need for that authority is based upon economic conditions, we do not favor any fixed, statutory deadline on the exercise of the authority. A premature reestablishment of normal prudential standards could set back a recovery. Instead, we suggest that Congress give the Federal regulator some economic markers or metrics that the regulator can monitor to determine when it is appropriate to reinstate prudential standards. Potential markers could be a leveling off of housing price declines and a leveling off of foreclosures.