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Capital Markets Special Report

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Issues and Challenges in Reforming the U.S. Housing Finance Market

The role of the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) — also referred to as government-sponsored enterprises, or GSEs — in the housing finance market has been debated for many years and became more of a focus in September 2008 when they were placed under conservatorship. On Feb. 11, 2011, the Obama Administration issued a report to the U.S. Congress that discussed the current state of the housing finance market and the need for reform. It included important measures that aim to address the fundamental flaws in today's mortgage market and begins to explore the optimal long-term structure of the housing finance market, including the future role of the GSEs.

Summary of "Reforming America's Housing Finance Market: A Report to Congress"

The Obama Administration's report acknowledges the need for changes to the current structure of the housing finance market, and it hopes to better protect taxpayers and improve the long-term health of the housing market going forward. The reform plan consists of three main objectives:

1. Pave the way for a robust private mortgage market by reducing government support for housing finance and wind down the GSEs on a responsible timeline.

In order for the private market to be able to play a more dominant role in the mortgage market, the plan calls for the winding down of the GSEs over an unspecified transition period. The initial steps suggested for doing so are as follows:

- *Increase guarantee fees charged by the GSEs* – would level the playing field. GSEs previously were able to issue capital at a lower cost vs. private market participants, which allowed them to charge lower fees. Going forward, the GSEs will be required to price their guarantees as if they were held to the same capital standards as private financial institutions. This would, therefore, increase the GSEs' cost of capital and likely translate into higher guarantee fees.
- *Increase private capital ahead of GSE guarantees* – with the use of private mortgage insurance and/or higher down payment requirements for borrowers (a minimum 10% down payment for a conforming loan).
- *Reduce conforming loan limits* – would reduce the maximum loan size that can be guaranteed by the GSEs. The conforming loan limit is currently at $730,000 and will be reset to $625,000 in October 2011. This limit has increased dramatically over time (with the limit at about $400,000 five years ago and about $200,000 in 1996) and partly contributed to the growth of the GSEs. Therefore, reducing the conforming loan limits will simply bring them more in line with historical levels and restrict continued growth of the GSEs.
- *Wind down the GSE investment portfolios* – would reduce the investment portfolios at an annual pace of no less than 10%. Their investment portfolios primarily consist of whole loan and securitized securities.

2. Address fundamental flaws in the mortgage market to protect borrowers, help ensure transparency for investors and increase the role of private capital.

Although the federal Dodd-Frank Wall Street Reform and Consumer Protection Act is expected to address some of the shortcomings of the mortgage market, the report outlines a number of additional reforms to protect borrowers and promote the stability of the housing finance market. These additional reforms are as follows:

- *Increase transparency and accountability in the securitization chain* – through stricter reporting and disclosure requirements and the requirement of risk retention.
- *Increase capital standards for banks* – would improve the safety and stability of the financial system.
- *Strengthen regulatory oversight* – with the Financial Stability Oversight Council (FSOC), created by the Dodd-Frank Act, monitoring systemic risk.
- *Improve mortgage servicing and foreclosure processing* – with the establishment of national standards and changes in servicing compensation to align industry incentives.

The first two bullet points above will likely result in increasing the cost of capital for the private sector, thereby increasing mortgage rates and reducing mortgage credit availability. Unfortunately, this directly conflicts with another important objective of the Obama Administration: providing affordable housing. Arriving at a functional balance among these competing goals could prove to be a difficult task.

3. Target the government's vital support for affordable housing in a more effective and transparent manner.

Ensuring Americans have access to an adequate range of affordable housing options is of utmost importance to the Obama Administration. In order to meet this goal, the report outlines the following areas of reform:

- *Reform and strengthen the Federal Housing Authority (FHA)* – to allow it to respond better to stress in the housing market and to manage risk more effectively.
- *Strengthen support for affordable rental housing.*
- *Ensure that capital is available to credit-worthy borrowers in all communities*.
- *Support a dedicated funding source for targeted homeownership and rental affordability* – would be a newly developed financing mechanism that provides additional resources to low- and moderate-income households.

One of the most significant areas of reform, in our opinion, is the winding down of the GSEs and the ultimate long-term structure of the mortgage market. Unfortunately, the report does not set forth a specific proposal to address this area. It simply offers three options, from which the Obama Administration and Congress can begin a healthy discussion, but does not indicate a preference for any of the options provided. The three options are as follows:

- Option 1: Privatized system of housing finance with no government support or intervention.
- Option 2: Privatized system of housing finance with a guarantee mechanism to scale up during times of crisis only.
- Option 3: Privatized system of housing finance with catastrophic reinsurance behind significant private capital.

According to the language in the report, the Obama Administration appears to be willing to continue its implicit guarantee of the GSEs, at least until implementation of the reforms begins. The report attempts to provide clarity with respect to the level of ongoing support and indicates that, "…it should be clear that the government is committed to ensuring that Fannie Mae and Freddie Mac have sufficient capital to perform under any guarantees issued now or in the future

and the ability to meet any of their debt obligations." However, it remains to be seen whether Congress holds the same view. For now, though, ratings on existing securities (direct and indirect obligations) were not affected by the Obama Administration's report to Congress. Based on the current proposals, the government and the GSEs will be playing a diminished role in the housing finance market in the future. However, it remains unclear for now what role, if any, either will play or what the long-term structure of the housing finance market will look like. We expect the development of a definitive reform plan that all parties agree on will be a long process, due to the complexity of reforming a market that can have a major impact on the economy and impacts several public-policy areas.

Analysis of the Long-Term Reform Options

Although no timeline was provided for the reform of the housing finance market, we do not foresee any significant changes being made within the next 12 months. The Obama Administration did not provide a clear strategy for or path to reform, and common ground must still be found with Congress before moving forward. In addition, the housing market and economy are still in recovery mode, so further improvement and stability are likely needed before significant changes can be made. Both parties want to reestablish a stable housing finance market where private capital is the primary source for mortgage financing, but it is unclear at this point as to how that will be accomplished. The three options presented in the Obama Administration's report provide some insight into the potential long-term structure of the mortgage finance market, but clarity and details are still lacking.

Option 1

The first option is a mortgage market that is fully supported by private capital, with no support or intervention from the federal government (aside from the role played by the Federal Housing Administration (FHA), U.S. Department of Agriculture (USDA) and U.S. Department of Veterans Affairs to provide affordable housing to targeted individuals). The strengths of this option are that moral hazard and the risk of future taxpayer bailouts are greatly reduced. However, with the complete withdrawal of the government's support, it is unclear whether a mortgage market financed by private capital would offer today's typical pre-payable 30-year, fixed-rate mortgage. Private capital might view a 30-year, fixed investment as too risky, especially if it is required to retain some of the risk it originates. In addition, mortgage rates would certainly increase, thereby jeopardizing the affordability of mortgage financing.

Option 2

Option 2 is a mortgage market run by private capital, but with the government intervening to ensure access to credit during a housing crisis. The mechanics of this backstop have not been developed, so there is a great deal of uncertainty around how well it would be able to scale up in times of crisis. This option would also likely result in an increase in mortgage rates. Unlike Option 1, the government would be in a better position under this option to manage a downturn in the housing market, stepping in to ensure the availability of credit and stabilizing a declining market.

Option 3

The final option is a mortgage market run by private capital with the government providing reinsurance for certain securities, thereby increasing liquidity in the secondary mortgage market, as well as access to mortgages. The government reinsurance would only be provided if private mortgage reinsurance was already in place and would only pay out if the shareholders of the private mortgage insurers had been entirely depleted. The presence of the government reinsurance could potentially attract a larger pool of investors to the mortgage market, resulting in increased liquidity and, therefore, lower mortgage rates. However, mortgage rates under this option would still likely be higher than today's rates, but would not be as high as they would be under the first two options. This option has the most risk of moral hazard and taxpayer bailouts, given the government's increased involvement in the market.

The Obama Administration's report does not provide any insight into who will be providing the private mortgage reinsurance. A relatively small group of private mortgage insurers exist in today's market, but they experienced significant stress during the financial crisis and continue to face capital challenges and unprecedented losses today. As a result, sufficient and fresh private capital would need to be attracted to the market and to be willing to bear risk in order for this option to work effectively.

Reforming the U.S. housing finance market will impact three important aspects of the housing market: 1) housing affordability; 2) mortgage rates; and 3) mortgage credit availability. The possibility that the 30-year fixed-rate mortgage is no longer an option for borrowers would greatly reduce the affordability of housing. Mortgage rates will likely increase from today's levels due to 1) the cost of capital for private capital being greater than that for the GSEs; 2) risk-retention requirements resulting in higher capital requirements; and 3) higher costs of doing business from increased reporting and disclosure requirements as mandated by the Dodd-Frank Act. Finally, mortgage credit availability will likely be less than in the past with the requirement for higher down payments, lower conforming loan limits and reductions in borrower eligibility. The impact on these three factors could potentially put the recovery of the housing market at risk, or at least postpone it for some time.

The Future of Fannie Mae and Freddie Mac

All three of the options presented in the Obama Administration's housing finance report call for the winding down of the GSEs. However, it is unclear whether the GSEs will be completely eliminated over time or if they will continue to exist in some form or capacity. As mentioned previously, an ultimate conclusion as to the future of the GSEs will take some time, but we will briefly discuss two possible scenarios.

Let's assume the GSEs are wound down to a fraction of what they are today, allowing for private capital to reenter the mortgage market and the GSEs to continue playing a role, albeit greatly diminished, in the mortgage market. Ultimate ratings would depend on how the entities were capitalized and the level of government support. Assuming a clear and strong level of support from the federal government, ratings could remain at the same level as the U.S. sovereign rating (or within the vicinity). Without any government guarantee, however, the ratings would almost certainly be downgraded and would largely be dependent on the level of capitalization and the ultimate role of the entity in the mortgage market.

Let's assume the GSEs are wound down completely over time and no longer exist in the housing finance market in the long-term. This wind-down would undoubtedly take a number of years, given the almost $5.4 trillion of mortgage loans or securities that the GSEs own or guarantee. So, the question here is whether the federal government would continue to implicitly support the GSEs during this wind-down process or completely distance itself from the GSEs. Similar to the above scenario, the level of government support is critical to the ratings but, unfortunately, ongoing, long-term support of the GSEs remains highly uncertain.

The federal government is committed to financially supporting the GSEs through year-end 2012, with the GSEs allowed to request an unlimited amount of senior preferred capital on a quarterly basis. In 2013, however, Fannie Mae will be limited to $125 billion in capital and Freddie Mac will be limited to $149 billion. So, in our view, this sets a "soft" deadline for when the Obama Administration and Congress need to have made progress in determining the most prudent manner to reform the housing finance market (or at least provide clarity on what direction reform is headed). If there is no certainty by mid- to late 2012, it could potentially lead to instability in the housing market.

In both of the above scenarios, the question arises whether there is sufficient private capital to fill the void that will be created as the GSEs are wound down. Banks are viewed as a likely candidate to step in, but the extent of their participation partly depends on their ultimate cost of mortgage origination. Unfortunately, new transparency and capital requirements to be established under the Dodd-Frank Act will likely increase the cost of mortgage origination.

Before the dramatic growth in the GSEs, the banks were significant players in the mortgage market. However, the long cash flows related to mortgages did not match well with their short-duration liabilities. Disintermediation was a serious problem when depositors withdrew their funds, revealing the asset-liability mismatch. The growth of GSEs, and involvement of the capital markets through securitization, allowed the banks to play a less dominant role. Given that the asset-liability mismatch would still exist today, it is uncertain if the banks would be willing to again play a significant role in the mortgage market. Other potential candidates that could provide additional capacity are independent mortgage finance companies. Although some mortgage finance companies did not fare well during the financial crisis, the business model could still be viable if they are adequately capitalized and manage risk properly.

Impact on the Insurance Industry

Reforms to the U.S. housing finance market will impact the insurance industry in a variety of ways, including the value of certain investments in invested asset portfolios; the types of investment options available in the market; and investment strategies given different investment options. As more details and clarity are provided, additional issues and concerns might arise that could affect the insurance industry further.

The market value of existing direct obligations of the GSEs (or securities that are guaranteed by the GSEs) could see additional volatility with an increase in uncertainty of the GSEs' future. The extent to which the asset values will decline, however, is difficult to gauge at this point. In the unlikely scenario of reduced support from the federal government (whether explicit or implicit) for existing obligations, the likelihood of losses will undoubtedly arise for direct obligations, as well as for guaranteed securities. In addition, the level of recapitalization will play a key role in the ultimate ratings of the GSEs if there is no government support and could, therefore, compound losses even further if capitalized weakly. Furthermore, the value of guaranteed securities also would be dependent on the quality and performance of the underlying collateral. However, in the interim (i.e., between now and when an ultimate resolution is reached), there is the possibility that investors become concerned with the lack of long-duration bonds in the market going forward, as the GSEs were significant issuers in this particular market segment. Assuming the government's guarantee remains in place, insurance companies — particularly life companies — and other long-duration investors could potentially begin to buy long-duration bonds in anticipation of a dearth of supply in the future. This demand would increase prices for the GSEs' long-duration bonds.

With the government reducing its participation in the housing finance market, private capital is expected to play an increased and more important role in the market. It is unknown, though, how much risk private capital will be willing to take and whether it is willing to bear the interest rate and credit risk associated with a 30-year fixed-rate mortgage. Going forward, risk might possibly be shared by a number of parties (e.g., homeowners, mortgage originators, banks, mortgage securitizers, mortgage insurers and investors) as each party retains some risk on their books. This could potentially lead to higher yields for insurance companies and investors, but at the expense of increased risk.

Reforms in the housing finance market could potentially lead to the development of a covered bond market in the United States. A covered bond is a "dual recourse" security in which bondholders have recourse to the issuing bank first and then to a pool of high-quality collateral in the event of default. A robust covered bond market could provide banks with an additional source of financing for mortgage originations. However, before that can happen, regulations that clearly define eligible assets for asset pools — and, most important, how covered bonds will be treated in the event of a bank default — are necessary. Covered bonds could potentially be an attractive investment for insurance companies if a liquid and transparent market is developed. The European Union has a robust covered bond market, with covered bonds representing the second-largest segment of the European bond market after government bonds. At the end of 2009, there was €1.6 trillion in outstanding covered bonds that were backed by high-quality

mortgage loans. Europe has legislation in place that addresses topics such as which types of assets are eligible to back covered bonds, the minimum quality requirements for those assets, how the asset pools are to be monitored, and how investors are protected in the event of a bankruptcy. However, it would take some time before legislation would be in place to support a covered bond market in the United States, and it remains to be seen whether it would make a meaningful impact in providing private capital with additional financing for mortgage originations.

Investment options that are popular in today's market might not exist after reforms have taken place in the mortgage market. At the same time, new investment options could arise. With these potential changes in investment options, insurance companies might have to rethink their investment strategies. For example, most insurance companies historically viewed the long-duration securities issued or guaranteed by the GSEs as relatively low risk and a good match for their liability structure. Given the expected diminished role of the GSEs in the mortgage market going forward, an alternative investment will have to be found to replace the relatively attractive risk/return profile that the GSEs provided before the financial crisis. Given that we are in the initial phase of the housing finance market reform, it remains to be seen whether such an investment will materialize.

In addition, insurance companies will likely take on added credit risk if they turn to the non-agency residential mortgage-backed securities (RMBS) market to make up for the decline in agency RMBS transactions, which essentially only carry interest rate risk because the credit risk is fully assumed by the GSEs. If the non-agency RMBS market is able to return to the robust levels it enjoyed before the financial crisis, insurance companies will need to make sure that they are well-equipped and well-capitalized to manage the additional credit risk.

In conclusion, the Obama Administration and Congress have a difficult task ahead of them: to achieve a delicate balance between ensuring availability of affordable mortgage credit and limiting the federal government's role in the housing finance market. Many questions remain regarding how this balance will be accomplished. We will continue to monitor developments in the mortgage market and analyze their impact on the insurance industry, if any.

March 11, 2011

Major Insurer Share Prices

			Change %			Prior		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Life	Aflac	$55.55	(3.3)	(1.6)	(1.6)	$57.42	$56.43	$56.43
	Ameriprise	62.18	(1.7)	8.0	8.0	63.27	57.55	57.55
	Genworth	13.00	1.0	(1.1)	(1.1)	12.87	13.14	13.14
	Lincoln	30.28	(2.1)	8.9	8.9	30.92	27.81	27.81
	MetLife	45.85	0.6	3.2	3.2	45.57	44.44	44.44
	Principal	32.33	(2.0)	(0.7)	(0.7)	32.99	32.56	32.56
	Protective	27.18	(3.5)	2.0	2.0	28.18	26.64	26.64
	Prudential	63.10	(1.2)	7.5	7.5	63.87	58.71	58.71
	UNUM	26.32	1.2	8.7	8.7	26.02	24.22	24.22
PC	ACE	$61.39	(2.1)	(1.4)	(1.4)	$62.69	$62.25	$62.25
	Axis Capital	33.82	(6.8)	(5.7)	(5.7)	36.27	35.88	35.88
	Allstate	31.99	0.9	0.3	0.3	31.71	31.88	31.88
	Arch Capital	90.54	1.0	2.8	2.8	89.64	88.05	88.05
	Cincinnati	33.08	(0.5)	4.4	4.4	33.25	31.69	31.69
	Chubb	59.06	(0.6)	(1.0)	(1.0)	59.40	59.64	59.64
	Everest Re	83.52	(4.2)	(1.5)	(1.5)	87.20	84.82	84.82
	Progressive	20.85	(0.1)	4.9	4.9	20.88	19.87	19.87
	Travelers	58.88	(0.5)	5.7	5.7	59.18	55.71	55.71
	WR Berkley	30.26	2.3	10.5	10.5	29.57	27.38	27.38
	XL	22.22	(3.2)	1.8	1.8	22.95	21.82	21.82
Other	AON	$51.25	(0.4)	11.4	11.4	$51.46	$46.01	$46.01
	AIG	37.35	(0.1)	(22.6)	(22.6)	37.39	48.27	48.27
	Assurant	38.18	(2.3)	(0.9)	(0.9)	39.09	38.52	38.52
	Fidelity National	13.93	(1.1)	1.8	1.8	14.08	13.68	13.68
	Hartford	27.60	(3.5)	4.2	4.2	28.61	26.49	26.49
	Marsh	30.27	0.1	10.7	10.7	30.24	27.34	27.34
Health	Aetna	$36.50	(4.8)	19.6	19.6	$38.34	$30.51	$30.51
	Cigna	43.57	(0.6)	18.8	18.8	43.82	36.66	36.66
	Humana	64.45	(0.2)	17.7	17.7	64.56	54.74	54.74
	United	43.59	(1.9)	20.7	20.7	44.45	36.11	36.11
	WellPoint	67.98	(0.0)	19.6	19.6	67.99	56.86	56.86
Monoline	Assured	$14.26	3.2	(19.4)	(19.4)	$13.82	$17.70	$17.70
	MBIA	10.27	(2.0)	(14.3)	(14.3)	10.48	11.99	11.99
	MGIC	8.58	2.9	(15.8)	(15.8)	8.34	10.19	10.19
	PMI	2.85	(2.4)	(13.6)	(13.6)	2.92	3.30	3.30
	Radian	7.00	(2.2)	(13.3)	(13.3)	7.16	8.07	8.07
	XL Capital	22.22	(3.2)	1.8	1.8	22.95	21.82	21.82

March 11, 2011

Major Market Variables

			Change %			Prior		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Dow Jones Ind		12,044.40	(1.0)	4.0	4.0	12,169.88	11,577.51	11,577.51
S&P 500		1,304.28	(1.3)	3.7	3.7	1,321.15	1,257.64	1,257.64
S&P Financial		222.56	0.2	3.6	3.6	222.13	214.77	214.77
S&P Insurance		196.24	(0.7)	4.3	4.3	197.60	188.22	188.22
US Dollar $			**Change %**			**Prior**		
	/ Euro	$1.39	(0.6)	3.9	3.9	$1.40	$1.34	$1.34
	/ Crude Oil bbl	101.16	(3.1)	9.7	9.7	104.42	92.22	92.22
	/ Gold oz	1,421.80	(0.5)	0.1	0.1	1,428.60	1,420.78	1,420.78
Treasury Ylds %		**%**	**Change**			**%**	**%**	**%**
	1 Year	0.23	(0.01)	(0.04)	(0.04)	0.24	0.27	0.27
	10 Year	3.41	(0.09)	0.11	0.11	3.49	3.30	3.30
	30 Year	4.55	(0.05)	0.21	0.21	4.60	4.34	4.34
Corp Credit Spreads -bp			**Change %**			**Prior**		
	CDX.IG	86.08	3.0	1.3	1.3	83.55	85.00	85.00
	CDX.XO	144	(11.9)	(24.9)	(24.9)	163.5	191.67	191.67

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.

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