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By electronic delivery to: www.FHFA.gov

The Federal Housing Finance Agency
Office of Policy Analysis and Research
400 7th St. SW
Ninth Floor
Washington, DC 20024

Re: Fannie Mae and Freddie Mac Guarantee Fees – Request for Input

Ladies and Gentlemen,

Essent Guaranty, Inc. ("Essent") is a private mortgage guaranty insurer licensed nationwide. Private mortgage insurance ("MI") protects residential mortgage lenders and investors from credit losses by paying claims from private capital when a borrower defaults on an insured loan. Essent is pleased to be a major provider of MI coverage to Fannie Mae and Freddie Mac (the "GSEs"). We believe our commitment to prudent risk management, strong capital and a sound contract are reflected in our investment grade ratings and make MI coverage from Essent a superior product in the market for lenders, and policyholders such as the GSEs. Importantly, MI remains an affordable and accessible source of private capital serving borrowers by working effectively for lenders of all sizes while protecting taxpayers. The use of MI at origination by lenders, before loans are guaranteed by the GSEs, provides taxpayers significant risk mitigation and reduces the credit risk needed to be retained and managed by the GSEs on behalf of taxpayers.

We appreciate that the Federal Housing Finance Agency ("FHFA") is requesting comment through a Request for Input ("RFI") released June 5th, 2014 on the guarantee fees that the GSEs charge to lenders. We note that concurrently, FHFA has requested input on updated, aligned Private Mortgage Insurer Eligibility Requirements (the "PMIERs") that establish strong standards for MI companies that ensure the capacity to fully pay claims under conditions of economic stress. Because of the important role of MI absorbing credit risk before the GSEs issue their guarantee, we believe that many questions related to GSE guarantee fees are closely intertwined with the risk mitigating benefits of MI assured by the PMIERs. Essent has submitted comments on the proposed PMIERs concurrently with these comments, which may be read in concert with the views we express herein.

The RFI states that the GSEs charge both ongoing and upfront guaranty fees, and such upfront fees are generally referred to as loan level price adjustments ("LLPAs"). Both ongoing and upfront fees serve the purpose of compensating the GSEs for providing a credit guarantee. Herein, we use the term, "g-fees," to refer to the effective economic cost of both ongoing and upfront guarantee fees unless otherwise specified.

Essent's Overarching Recommendation

We recommend that FHFA take one specific set of actions on g-fees that we see as fully consistent with applicable law and prudent policy that would benefit low-wealth borrowers while reducing taxpayer exposure. We view this as a unique opportunity to enhance access and affordability for borrowers most in need of such help without sacrificing safety and soundness. These steps are the following:

1. Withdraw the proposed g-fee increases from December 2013;

2. Expeditiously finalize the proposed PMIERs with strong MI capital standards;

3. Revise the g-fee framework for above 80% LTV loans with MI coverage so that g-fees charged to lenders fully recognize the risk mitigating benefit of first loss coverage provided by a PMIERs compliant MI company. These fee reductions can be readily implemented by reducing LLPAs on such insured loans; and,

4. Set the implementation of LLPA reductions for these loans to begin within six months of the publication of the final PMIERs, when MI companies must first certify to compliance with the new requirements. Such an approach provides all MIs with time to achieve compliance. Reduced g-fees for low down payment loans will not only benefit borrowers, but will also create strong incentives for timely compliance with the PMIERs by MI companies.

We believe that this strategy can achieve a meaningful reduction in g-fees for borrowers in the vital low down payment segment of the mortgage market, while providing strong MI capital ahead of taxpayers insuring the first loss position. The competitive nature of the private MI industry and the public statements of all members of the MI industry that they anticipate meeting the proposed PMIERs standards assure a robust and competitive market for MI coverage. Opportunities for policy change that can enhance private capital while lowering costs to deserving low down payment borrowers are rare, and this is one such instance. We recommend that this opportunity be promptly grasped.

Summary of Essent's Complete Responses and Recommendations

The process of setting GSE g-fees, including the credit given for private MI that absorbs credit risk before the GSEs place their guarantee, will be instrumental to the market and will determine the risks retained by taxpayers through an extended period of conservatorship. The RFI comes after a period when Congress and the Administration have spent considerable time and effort examining ways to reform the housing finance system of the United States. A broad consensus has developed that the direction of reform should favor a larger role for private capital resulting in taxpayer risk exposure being greatly reduced and more remote. FHFA's own recent strategic plans, as well as that proposed for 2015-2019, have set as a goal to reduce GSE risk exposure to taxpayers. At the same time, ensuring broad access and affordability for borrowers and providing a secondary market system accessible by lenders of all sizes remain important policy objectives. We believe the role of MI fundamentally addresses the challenge of expanding sustainable access and

affordability while reducing taxpayer risk, and in this context we offer a summary of key responses to the RFI as well as detailed responses to specific questions.

1. Formally Withdraw Proposal for Further G-fee Increases

The g-fee increases proposed in December 2013 should not be adopted and we applaud Director Watt for putting these arbitrary increases on hold. This proposal should now be formally withdrawn because g-fees should not be artificially raised to "crowd in" private capital. The effort to "crowd in" private capital through raising g-fees either pushes borrowers into a poorly functioning private label security ("PLS") market that continues to face structural challenges, or onto balance sheets of depository lenders that themselves have taxpayer backing, creating systemic risk issues by encouraging long-term funding with short-term borrowing. Because the PLS market faces structural challenges, including policy and regulatory uncertainty and a lack of investor confidence, even very large g-fee increases might not stimulate a liquid and well-functioning PLS market. Moreover, such an approach to g-fees is not consistent with statutory mandates or fulfillment of the mission of the GSEs. Even at their highest volumes, PLS markets have not provided low, moderate and middle-income borrowers with the benefits of a reliable, liquid 30-yr fixed rate mortgage enabled by a federal catastrophic backstop.

2. Statutory Requirements and Good Policy Favor "Fair Market G-fees"

There is a clear statutory requirement that g-fees reflect the pricing of a fully private, regulated financial institution, herein referred to as "fair market g-fees." Specifically, Congress mandated that g-fees should, ". . . appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions. . . .," as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (PL 112-78, "TCCA"). We believe this law is very clear and intends g-fees to reflect market pricing for credit risk, including the cost of expected losses, and the cost of holding sufficient capital against the risk and earning a market return on that capital. This statutory requirement contemplates neither arbitrary increases in g-fees to "crowd in" private capital nor setting average g-fees to earn below-market returns for the risk being borne by taxpayers in order to provide overall market subsidies. Well-capitalized private MI companies, as regulated monoline holders of credit risk operating in a competitive market, provide an optimal reference point for the pricing of credit risk consistent with the TCCA requirement.

Fair market g-fees best fulfill the mission of the GSEs and the Housing and Economic Recovery Act ("HERA") requirement that FHFA preserve and conserve the assets of the GSEs, in addition to fulfilling statutory requirements. A brief consideration of the alternatives readily reveals the compelling logic of a framework based on fair market g-fees. One alternative would be charging g-fees well above fair market, which would impose an unfair burden on borrowers and hinder mortgage access and affordability, contrary to the mission of the GSEs. The other alternative would be charging g-fees well below fair market, which would preclude private sector credit risk bearers from shifting risk away from taxpayers because they could not compete with government-subsidized g-fees, thereby locking in the current taxpayer risk model. Below market fees are also inconsistent with FHFA's mandates to preserve and conserve the assets of the GSEs and to operate the GSEs in a sound and solvent manner.

3. G-fees Should Be Set to Fully Value MI Risk Mitigation

Haircuts to the value of private MI currently reflected in GSE g-fees should be removed for MI companies that fully comply with the financial requirements of the PMIERs, permitting a reduction in g-fees to low-down payment borrowers that are currently paying needlessly high fees. In setting economic capital, the GSEs should fully reflect via reduced capital charges and provision for expected losses, the full risk-mitigating benefits of MI placed on loans before the loans are guaranteed by the GSEs.[1] While the current average cost of credit protection (approximately 55-65 bps) charged by the GSEs appears to be reasonable for the underlying overall risk, the apparent lack of full recognition of the credit protection provided by MI results in an overall charge that is plainly too high on mortgages with above 80 percent loan-to-value ("LTV") ratios. As shown on **Exhibit 1** to this letter, for loans with an LTV of 90% at selected credit scores, the g-fees currently charged by the GSEs for their second loss position exceed the premiums being charged by MI companies for first loss exposure by 17 to 21 bps per annum. Essent estimates find that while MI coverage accounts for approximately 70% of expected losses on these loans, MI premiums represent approximately 33% of the total credit costs paid by borrowers because of the large impact of GSE g-fees. **Exhibit 1** also shows how much higher the disparity in GSE g-fees as compared to MI premiums would have become had the December 2013 proposed g-fee increases gone into effect. For example, GSE g-fees would have risen by 37 bps on a 90% LTV loan with a 720 FICO score.

These high costs fall on generally lower-wealth borrowers, who appear to be paying twice for the same risk coverage. Full recognition of MI would lower costs for these borrowers and should be afforded to coverage provided by MI companies that are compliant with the PMIERs. Full recognition of MI is warranted in light of the PMIERs' prudential, risk-based capital framework designed to ensure that qualified MIs will be able to pay all claims in a severely stressful economic environment. These rigorous financial standards, combined with comprehensive requirements related to MI business practices and operations and subject to extensive GSE oversight, will provide the GSEs and other MI industry counterparties exceptional confidence in the claims paying ability of MI companies meeting the new standards.

4. Capital Markets "Risk Syndication" Should Not Be Used to Set G-fees or Price Risk

GSE capital markets credit risk "syndication" transactions have limited value as price discovery experiments and should not be used in setting g-fees or pricing credit risk. There are significant problems with drawing conclusions about the market price of credit risk or how g-fees should be established from the structured finance back-end "risk syndication" transactions recently executed by the GSEs. These include that (1) the risk is acquired, aggregated and seasoned by the GSEs prior to being distributed; (2) complex structuring is utilized with the GSEs retaining significant first loss and basis risk in order to structure risk distribution to the preferences of bond investors; (3) understanding the pricing of credit risk for any particular loan within a transaction is nearly impossible insofar as pricing is known only at the overall tranche level and not for any individual loan; (4) pricing is heavily influenced by the leverage provided to these structures in the repo market; and (5) the effects of the implicit subsidy and liquidity value of GSE debt are

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[1] This would be the case with other similarly well-capitalized and regulated private credit enhancements.

intertwined with the economics of the transactions. The inherent instability of the capital markets and unreliability of these funding sources makes these transactions very difficult to rely upon as an indicator of appropriate credit risk pricing through the cycle. These transactions are best considered an opportunistic and volatile partial hedge of GSE credit risk requiring a complex "aggregate to distribute" business model reliant on capital markets that have proven unreliable in times of stress. A preferable benchmark for establishing fair market g-fees would be based on loan level credit enhancement provided to lenders by a well-capitalized, competitive private MI industry proven to operate through the credit cycle.

5. Expanding Upfront MI Provides Optimal Solution to G-fee Questions

We recommend that expanded upfront credit enhancement using MI be implemented in order to optimally determine fair market g-fees while at the same time lowering costs and expanding access for borrowers, increasing the role of private capital, placing taxpayers at a more remote risk of loss, simplifying the operations of the GSEs and lessening the substantial burden on FHFA to discover the market prices for credit risk. Upfront use of MI is the reliable alternative to GSE bearing of credit risk that is understood and accessible by thousands of lenders of all sizes and preserves a well-functioning, affordable secondary market. Specifically, we recommend:

Identify and test fully private regulated financial institution pricing for credit risk by permitting lenders to acquire deeper credit enhancement from well-capitalized MI companies, coupled with requiring the GSEs to provide a bona fide reduced g-fee pricing option that fully reflects the GSEs' reduced risk exposure. The FHFA should define a level of protection sufficient to leave the GSEs in only a very remote risk of loss position (a "catastrophic risk" position) before they issue their guarantee, and require the GSEs to provide g-fees commensurate with only accepting such a "cat risk" exposure. When the GSEs are in a very remote risk position at the time they issue their guarantee, the g-fees charged to lenders should be quite low, in the range of 6-16bps[2], covering only GSE operating expenses, a very small residual risk of loss and compensation for the federal backstop. As a comparison, Ginnie Mae has been profitable through the crisis despite charging only a 6 bps guarantee fee because it plays a limited "back stop" role with the predominant risk of credit loss borne first by government-supported mortgage insurance and secondarily by lenders. Requiring the GSEs to provide cat risk-only g-fees to lenders reduces the burden on FHFA to set prices for credit risk in the absence of critical market signals such as the input of investors with capital at risk and real competitive forces which do not exist given the FHFA conservatorship of both GSEs. Such an approach also creates incentives for an expanded role by private capital taking risk ahead of taxpayers, and simplifies the operations of the GSEs.

Upfront risk-sharing pilots should be initiated with one pilot structure being deep loan-level MI coverage obtained by lenders from well-capitalized MI companies that results in a net LTV<=50%. Such an approach would encourage the expanded use of private capital with MI coverage ahead of taxpayers that can be readily implemented now by lenders of all sizes. Such a pilot would shift the burden to set prices for credit risk from FHFA to a competitive market with private capital at risk. This pilot would test pricing in a market of MI companies competing to serve

[2] The lower end of the range reflects the fees charged by Ginnie Mae, which provides a catastrophic risk guarantee on MBS very similar to the "cat risk" position proposed to be tested. The upper end of the range provides for a more generous fee to the federal government, on the order of 10bps, for the backstop provided to MBS holders, as well as a higher level of operating expenses than incurred by Ginnie Mae.

lenders and would test GSE pricing for a materially reduced net risk position as a very significant step toward a cat risk exposure and price. This pilot would be an option for lenders to use if the additional credit enhancement reduced the net cost of execution in the secondary market. Because lenders would only exercise this option if it lowered total credit costs, it would only serve to improve credit access and affordability, with credit costs capped by GSE g-fees for unenhanced loans.

The expanded use of upfront credit enhancement with MI is the most effective tool for the GSEs to manage the net risk exposure that might occur from changes in the mix of business being originated or securitized. The GSEs currently are exposed to increased risk if the profile of business shifts to a riskier mix. Mitigation of this risk has been reflected in very conservative underwriting and eligibility standards and increased use of risk-based pricing by the GSEs. This risk can be more effectively controlled by utilizing MI upfront to place private capital ahead of taxpayer risk, and shifting the burden of assessing and bearing the credit risk on a loan-by-loan basis to an independent set of eyes. For example, 95% LTV loans currently require 30% MI coverage, resulting in a net effective LTV of 67%. Loans at 80% LTV have no such coverage and represent a higher severity of loss to the GSEs should the loan default. The use of sufficient MI resulting in the GSEs holding only a remote "cat risk" loss position, as we recommend above, would fully mitigate the risk of changes in the risk profile of securitized loans by transferring the profile risk from the GSEs to well-capitalized MIs.

Conclusion

We thank FHFA for the opportunity to comment on the important questions related to the framework for establishing GSE g-fees. As noted in our discussion, the choices with regard to g-fees will have a significant impact on mortgage borrowers, lenders, other market participants and taxpayer risk. Our recommendations favor a policy direction, consistent with statutory requirements and FHFA's own strategic plans, that can expand the role of private capital through well-capitalized mortgage insurance while preserving, and indeed expanding credit access and affordability. If adopted, our recommendations would enable competitive, private capital to play a more substantial risk bearing role ahead of taxpayer risk while preserving the liquidity benefits to low, moderate and middle income borrowers of the federal backstop supporting GSE securitization. One key recommendation is to immediately address high LLPAs being charged to low down payment borrowers on the basis of the adoption of new, prudential PMIERs applicable to all MI companies. Reducing LLPAs can provide the vital low down payment segment of the market with immediately improved affordability, while creating strong incentives for GSE MI counterparties to be well-capitalized on a timely basis. This is a unique policy opportunity to strengthen private capital while improving affordability that should be quickly seized.

Sincerely,

Adolfo F. Marzol
Executive Vice President

Exhibits

1: Effective GSE Guaranty Fee vs. Mortgage Insurance Premium by FICO

2: Essent's Responses to G-fee Questions Posed by FHFA

3: Essent's Comments on FHFA's Proposed PMIERs, Dated September 8, 2014

Exhibit 1

Effective GSE Guaranty Fee vs. Mortgage Insurance Premium by FICO: 90 LTV

Item	680	720	760	Notes
A) Current G-Fee	0.78%	0.62%	0.56%	= estimate of current base g-fee and annualized LLPAs
B) Proposed G-Fee	1.11%	0.99%	0.77%	= estimate of proposed base g-fee and annualized LLPAs
C) LPMI Monthly Premium	0.57%	0.44%	0.39%	= commonly published MI industry premium rates
D) Total Borrower Fee - Current	1.35%	1.06%	0.95%	= A + C
E) Total Borrower Fee - Proposed	1.68%	1.43%	1.16%	= B + C
F) GSE Share of Current Total Borrower Fee	58%	58%	59%	= A ÷ D
G) MI Share of Current Total Borrower Fee	42%	42%	41%	= C ÷ D
H) GSE Share of Proposed Total Borrower Fee	66%	69%	66%	= B ÷ E
I) MI Share of Proposed Total Borrower Fee	34%	31%	34%	= C ÷ E
J) MI Insurance Coverage Percentage	25%	25%	25%	= contractual MI coverage level
K) GSE Gross "Normal Environment" Severity (95% weight)	35%	35%	35%	= estimate of avg. gross loan losses given default
L) GSE Gross "Stress Environment" Severity (5% weight)	60%	60%	60%	= estimate of avg. gross losses given default during stress
M) MI Share of 'Expected" Losses	69%	69%	69%	= J ÷ (95% x K + 5% x L)
N) GSE Share of "Expected" Losses	31%	31%	31%	= 1 - M

Exhibit 2: Essent's Responses to G-fee Questions Posed by FHFA

Question 1. Are there factors other than those described in Section III – expected losses, unexpected losses, and general and administrative expenses that FHFA and the Enterprises should consider in setting g-fees? What goals should FHFA further in setting g-fees?

Statutory requirements and good public policy favor g-fees that reflect the pricing of fully private, regulated financial institutions, herein referred to as "fair market g-fees." In addition, g-fees should fully reflect the risk-mitigating benefits of private MI placed on loans before the GSEs have issued their guarantee. We recommend that implementation of the statutory guidance and sound policy should further the following goals:

1. Optimally determining fair market g-fees;
2. Lowering costs and expanding access for borrowers;
3. Increasing the role of private capital while placing taxpayers in a more remote risk of loss;
4. Simplifying the operations of the GSEs; and
5. Lessening the substantial burden on FHFA to set the market prices for credit risk in the U.S. housing market.

In December 2011, Congress passed and President Obama signed H.R. 3765, the Temporary Payroll Tax Cut Continuation Act of 2011 (PL 112-78) or "TCCA." Included in this bill was language that required a 10 basis point increase in GSE g-fees to be used to "pay for" an extension of the payroll tax holiday. This bill also contains language requiring the GSEs to price g-fees at levels equivalent to "fully private regulated institutions." The language from Sec 401(b)(1)(B) of the legislation specifically states:

> *Amount.--The amount of the increase required under this section shall be determined by the Director to appropriately reflect the risk of loss, as well the cost of capital allocated to similar assets held by other fully private regulated financial institutions, but such amount shall be not less than an average increase of 10 basis points for each origination year or book year above the average fees imposed in 2011 for such guarantees. The Director shall prohibit an enterprise from offsetting the cost of the fee to mortgage originators, borrowers, and investors by decreasing other charges, fees, or premiums, or in any other manner.*

This language firmly establishes Congress' intent for g-fees to be priced in a manner that reflects the capital levels and return requirements required by fully private regulated financial institutions, which we refer to herein as "fair market g-fees." We believe that g-fees should be set to reflect the economic cost of the credit risk, as Congress mandated, utilizing sound actuarial analysis and appropriate market indicators. The economic cost should reflect the capitalization levels of private entities sufficient to stand behind their exposures under a severe stress environment and required to generate a market rate of return on their private capital. Well-capitalized MI companies, as fully private regulated monoline holders of credit risk operating in a

competitive market, provide an optimal reference point for the pricing of credit risk consistent with the TCCA requirement.

Fair market g-fees also best fulfill the mission of the GSEs and the HERA requirement that FHFA preserve and conserve the assets of the GSEs, in addition to fulfilling TCCA statutory requirements. A brief consideration of the alternatives readily reveals the compelling logic of a framework based on fair market g-fees. One alternative would be charging g-fees well above fair market, which would impose an unfair burden on borrowers and hinder mortgage access and affordability, contrary to the mission of the GSEs. The other alternative would be charging g-fees well below fair market. This would preclude private sector credit risk bearers from participation in shifting risk away from taxpayers because they could not compete with the government-subsidized g-fees, thereby locking in the current taxpayer risk model. Below market fees are also inconsistent with FHFA's mandate to preserve and conserve the assets of the GSEs and operating the GSEs in a sound and solvent manner.

In addition to these statutory provisions, g-fees should fully reflect the risk mitigation benefits of MI from well-capitalized MI companies on any loan delivered to the GSEs. The justification for full recognition is based on new, prudential standards promulgated by the GSEs under the direction of FHFA. Specifically, on July 10, new PMIERs were released for input that will, among other requirements, implement a capital framework which is designed to ensure that qualified MIs will be able to pay all claims in a severely stressful economic environment. These standards will provide industry counterparties, including the GSEs, with confidence in the claims paying ability of MI companies meeting the new standards. These important new standards, along with the October 1, 2014 implementation of new MI master policies which must meet an extensive set of GSE requirements developed under the oversight of FHFA, will clearly establish the MI industry's capacity and contractual obligations to pay claims. With these new standards in place, g-fees can fully reflect the risk mitigation provided by PMIERs-compliant MI companies. Essent's input on the FHFA's proposed PMIERs, dated September 8, 2014, is attached hereto as **Exhibit 3**.

Recognition of MI is especially important to borrowers who put less than 20 percent down on a home. While we believe that the overall average cost of credit protection currently being charged by the GSEs is reasonable for the inherent risk, on loans with down payments of less than 20 percent (i.e., those with LTVs above 80 percent) the apparent lack of full recognition of MI results in borrowers over-paying for credit protection and credit access being constrained. As shown on **Exhibit 1** to this letter, for loans with an LTV of 90% at selected credit scores, the g-fees currently charged by the GSEs for their second loss position exceed the premiums being charged by MI companies for first loss exposure by 17 to 21 bps per annum. Essent estimates find that while MI coverage accounts for approximately 70% of expected losses on these loans, MI premiums represent approximately 33% of the total credit costs paid by borrowers because of the large impact of GSE g-fees. **Exhibit 1** also shows how much higher the disparity in GSE g-fees as compared to MI premiums would have become had the December 2013 proposed g-fee increases gone into effect. For example, GSE g-fees would have risen by 37 bps on a 90% LTV loan with a 720 FICO score. Many of the borrowers that bear the brunt of these added costs are first time home buyers, new citizens and immigrants, and minority groups. These are segments of the population that policy makers and advocates believe are vitally important to serve with affordable and accessible mortgage credit. Recognizing the risk mitigation of well-capitalized MIs through lower g-fees would result in a net reduction in costs to lenders and borrowers as a result

of the use of private capital to reduce taxpayer risk, and would be an economically justifiable step towards increasing access to credit.

Given the TCCA requirement and policy rationale for fair market g-fees, the optimal way to identify and test fully private regulated financial institution pricing for credit risk is by permitting lenders to acquire deeper credit enhancement from well-capitalized MI companies, coupled with requiring the GSEs to provide a bona fide reduced g-fee pricing option that fully reflects the GSE's reduced risk exposure. The FHFA should define a level of protection sufficient to leave the GSEs in only a very remote (i.e., catastrophic or "cat risk") risk of loss position before they issue their guarantee, and require the GSEs to provide g-fees commensurate with only bearing a limited "cat risk" exposure. When the GSEs are in a very remote risk position at the time they issue their guarantee, the g-fees charged to lenders should be quite low in the range of 6-16 bps[3], covering only GSE operating expenses, a very small residual risk of loss and payment for the federal backstop. As a comparison, Ginnie Mae has been profitable through the crisis despite charging only a 6 bps guarantee fee because it plays just such a limited "back stop" role with the predominant risk of credit loss borne first by government-supported mortgage insurance and secondarily by lenders.

Progress toward identification of fair market g-fees can be made quickly if upfront risk sharing pilots are initiated with one pilot structure being deep loan-level MI coverage obtained by lenders from well-capitalized MI companies that results in a net LTV<=50%. Such an approach would encourage the expanded use of private capital with MI coverage ahead of taxpayers that can be readily implemented now by lenders of all sizes. This pilot would shift the burden to set prices for credit risk from FHFA to a competitive MI industry with private capital at risk. This pilot would test pricing in the MI market while also testing GSE pricing for a materially reduced net risk position as a very significant step toward a "cat risk" exposure and price. We propose these pilots as an optional execution for lenders to use if the additional credit enhancement reduces the net cost of execution in the secondary market. Because lenders would only exercise this option if total credit costs were reduced, it would thereby improve credit access and affordability, with credit costs capped by GSE g-fees for unenhanced loans.

Question 2: Risk to the Enterprises increases if the proportion of higher-risk loans increases relative to the proportion of lower-risk loans. This change in mix can occur if lower-risk loans are retained on bank balance sheets instead of being sold to the Enterprises, if more higher-risk loans are sold to the Enterprises, or if the overall mix of originated loans changes. What alternatives, other than risk-based pricing, should be considered? What are the pros and cons of each alternative?

The expanded use of upfront credit enhancement with MI is the most effective tool for the GSEs to manage the net risk exposure that might occur from changes in the mix of business being originated or securitized. The GSEs currently are exposed to increased risk if the profile of business shifts to a riskier mix. Mitigation of this risk has been reflected in very conservative underwriting and eligibility standards and increased use of risk-based pricing by the GSEs. This

[3] The lower end of the range reflects the fees charged by Ginnie Mae, who provides a catastrophic risk guarantee on MBS very similar to the "cat risk" position proposed to be tested. The upper end of the range provides for a more generous fee to federal government on the order of 10bps for the backstop provided to MBS holders, as well as a higher level of operating expenses than incurred by Ginnie Mae.

risk can be more effectively controlled by utilizing more upfront private credit enhancement to place private capital ahead of taxpayer risk, and place the burden of assessing and bearing the credit risk on a loan-by-loan basis. For example, 95% LTV loans currently require 30% MI coverage, resulting in a net effective LTV of 67%. Loans at 80% LTV have no such coverage and represent a higher severity of loss to the GSEs should the loan default.

The use of private credit enhancement sufficient to place the GSEs in a remote “cat risk” loss position prior to issuing their guarantee, as we recommend in response to Question #1, would fully mitigate the risk of changes in the profile of securitized loans, transferring the profile risk from the GSEs to well-capitalized MIs. In addition, this policy would be beneficial because it would create strong incentives to significantly expand the role of private capital and reduce the amount of risk the GSEs assume in a manner that is fully compatible with the current housing finance system in the United States, including the TBA market, and can result in lower costs to lenders and borrowers.

Question 3. Currently, target return on capital and the amount of capital largely determine required g-fees. What factors should FHFA and the Enterprises consider in setting target return on capital and amount of capital required? How should the Enterprises allocate capital across risk buckets?

We agree with the basic framework utilized by the GSEs to set g-fees to cover three types of costs expected to be incurred in providing their guarantee, described in the RFI as, “(1) the costs that the Enterprises expect to bear, on average, as a result of failure of borrowers to make their payments; (2) the costs of holding economic capital to protect against potentially much larger, unexpected losses as a result of failure of borrowers to make their payments; and (3) general and administrative (G&A) expenses. Collectively these three costs are the estimated cost of providing the credit guarantee.”

As addressed in our response to Question 1, Congress mandated that g-fees should, “. . . appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions, . . .” as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (PL 112-78) or “TCCA.” We believe the law provides clear guidance to FHFA on the fundamental manner in which g-fees should be set, reflecting the capital levels and return requirements expected from fully private regulated financial institutions. The economic cost should reflect the capitalization levels of private entities sufficient to stand behind their exposures under a severe stress environment and required to generate a market rate of return on their private capital. Well-capitalized MI companies, as fully private regulated monoline holders of credit risk operating in a competitive market, provide an optimal reference point for the pricing of credit risk consistent with the TCCA requirement.

In determining economic capital and required returns, FHFA should require the GSEs to reduce economic capital and expected losses for the full risk-mitigating benefits of MI placed on the loans before the loans are delivered to the GSEs. Full recognition of MI is warranted in light of the recently proposed PMIERs which, when finalized, will ensure the claims paying capacity of MI companies meeting the requirements, as well as new MI master policies, which reflect standardization of enhanced coverage terms across the MI industry. G-fees should fully reflect the risk mitigation benefits of MI on any loan when provided by a well-capitalized MI company,

permitting a reduction in g-fees to low down payment borrowers and the elimination of needless double charging for risk when insured by a PMIERs-compliant MI company.

Further, when the GSEs are in a remote "cat risk" position, as defined by FHFA, the g-fees charged to lenders should be quite low, we estimate in the range of 6-16 bps, covering only GSE operating expenses, a very small residual risk of loss and payment for the federal backstop. As a comparison, Ginnie Mae has been profitable through the crisis despite charging only a 6 bps guarantee fee because it plays a limited "back stop" role with the predominant risk of credit loss borne first by government-supported mortgage insurance and secondarily by lenders. Requiring the GSEs to provide "cat risk" only g-fees to lenders reduces the burden on FHFA to set prices for credit risk in the absence of critical market signals such as the input of investors with real capital at risk and real competitive forces which do not exist given the FHFA conservatorship of both GSEs. Such an approach also creates incentives for an expanded role by private capital ahead of taxpayer risk and simplifies the operations of the GSEs.

An important question with regard to setting economic capital is the inclusion of future g-fees as a source of capital. We believe economic capital requirements can be developed with or without the inclusion of future g-fees, and the choice of frameworks for a given application should consider the benefits of greater simplicity and transparency so long as the resulting capital requirements are well confirmed. Multiple capital frameworks leading to the same results provide important confirmation of the reasonableness of capital estimates. A "sources and uses" framework that estimates life of loan losses under a severe adverse economic scenario net of future g-fees (and other expected cash flows) is considered a useful framework for assessing economic capital because it captures the long-tailed and long-lived nature of mortgage credit risk. However, such a methodology is inherently more complex and requires a more substantial number of estimates and assumptions.

The allocation of capital to loans, or groups of loans, should be set on the basis of their contribution to the three components which determine the estimated cost of the GSE's guaranty and net of the costs absorbed by the risk mitigation of MI from a well-capitalized MI company. In this manner, the framework will provide the GSEs and FHFA appropriate economic risk and pricing signals for loans considered for guarantee by the GSEs. With regard to estimating expected losses, g-fees should reflect a reasonable expectation of current and likely future conditions. For example, loss severities should reflect current and likely conditions over the period of the guarantee rather than severities realized during the crisis.

GSE capital markets credit risk transfer transactions have limited value as price discovery experiments and should not be used in setting g-fees or pricing credit risk. There are significant problems with drawing conclusions about the market price of credit risk or how g-fees should be established from the structured finance back-end "risk syndication" transactions recently executed by the GSEs. These include that: (1) the risk is acquired, aggregated and seasoned by the GSEs prior to being distributed; (2) complex structuring is utilized with the GSEs retaining significant first loss and basis risk in order to structure risk distribution to the preferences of bond investors; (3) understanding the pricing of credit risk for any particular loan within a transaction is nearly impossible; (4) pricing is heavily influenced by the leverage provided to these structures in the repo market; and (5) the effects of the implicit subsidy and liquidity value of GSE debt are intertwined with the economics of the transactions. The inherent instability of the capital

markets and unreliability of these funding sources makes these transactions very difficult to rely upon as an indicator of appropriate credit risk pricing through the cycle. These transactions are best considered an opportunistic and volatile partial hedge of GSE credit risk requiring a complex "aggregate to distribute" business model reliant on capital markets that have proven unreliable in times of stress. A preferable benchmark for establishing fair market g-fees would be based on loan level credit enhancement provided to lenders by a well-capitalized, competitive private MI industry proven to operate through the credit cycle.

Question 4. At what g-fee level would private-label securities (PLS) investors find it profitable to enter the market or would depository institutions be willing to use their own balance sheets to hold loans? Are these levels the same? Is it desirable to set g-fees at PLS or depository price levels to shrink the Enterprises' footprints, even if this causes g-fees to be set higher than required to compensate taxpayers for bearing mortgage credit risk and results in higher costs to borrowers?

There is no statutory mandate to set g-fees at PLS or depository levels to shrink the footprint of the GSEs. Rather, Congress mandated that g-fees should ". . . appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions, . . ." as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (PL 112-78) or "TCCA." We believe this statute provides clear guidance to FHFA on the fundamental manner in which g-fees should be set and we provide further detailed comments in our response to Question #1.

Therefore, the g-fee increases proposed in December 2013 should not be adopted and we applaud Director Watt for putting these arbitrary increases on hold. This proposal should now be formally withdrawn because g-fees should not be artificially raised to "crowd in" private capital. The effort to "crowd in" private capital through raising g-fees either pushes borrowers into a poorly functioning PLS market that continues to face structural challenges, or onto balance sheets of depository lenders that themselves have taxpayer backing creating systemic risk issues by encouraging long term funding with short term borrowing. Because the PLS market faces structural challenges, including policy and regulatory uncertainty and a lack of investor confidence, even very large g-fee increases might not stimulate a liquid and well-functioning market. Moreover, such an approach to g-fees is consistent neither with statutory mandates nor fulfillment of the mission of the GSEs. Even at their highest volumes, PLS markets have not provided low, moderate and middle-income borrowers with the benefits of a reliable, liquid 30-yr fixed rate mortgage enabled by a federal catastrophic backstop.

We also caution against arbitrarily lowering g-fees to achieve "access and affordability", maintain market share, or achieve other policy objectives. Lowering fees in this way is inconsistent with the TCCA requirements and would not be consistent with FHFA's mandate to preserve and conserve the assets of the GSEs. Government access and affordability subsidies, where necessary, should be delivered by an appropriately targeted FHA insurance program.

Question 5: If the Enterprises continue to raise g-fees, will overall loan originations decrease? That is, will Enterprise loans decline without a commensurate increase in private capital?

Yes, we believe a material increase in g-fees would reduce mortgage originations and would not result in a commensurate increase in private capital. If g-fees are raised, some borrowers will

drop out of the system while others will seek other routes to obtain financing, likely fully-government alternatives of FHA, VA, and USDA. For low down payment borrowers taking these alternatives, taxpayers would bear all the credit risk. The perverse result of arbitrarily high g-fees would be less, not more, private capital.

Question 6: Is it desirable for the Enterprises to charge higher g-fees on low credit score/high LTV loans if it causes these loans to be insured/securitized through FHA/Ginnie Mae rather than through the Enterprises?

GSE pricing should reflect the underlying risk of the loans guaranteed. One of the lessons from the Great Recession was that widespread mispricing of credit risk resulted in lending to borrowers that were not ready to sustain homeownership, resulting in rapid defaults and poor performance in the downturn. The GSEs currently employ a risk-based pricing approach which, for the most part, sends reasonable pricing signals based on risk. However, as noted earlier, higher LTV borrowers are currently getting a non-economic price because of the apparent lack of full recognition for the value of MI. Credit access could be improved while retaining the appropriate pricing signals by eliminating these haircuts on the basis of the adoption of the PMIERs and new MI master policies. Lowering fees on high LTV loans to fully reflect the value of MI will also allow private MI-backed loans to compete more favorably with FHA.

More generally, the role of a governmental entity such as FHA providing credit insurance in competition to private mechanisms needs to be considered by housing policy makers. Currently, FHA is not targeted to borrowers that truly need full government backing, allowing borrowers or lenders to select FHA based on best execution versus need. We believe that is a problem to be solved by Congress and the Department of Housing and Urban Development by taking steps to target FHA to borrowers in need of full government backing and allowing the private market to serve as much of the market as possible consistent with robust access to credit. However, we strongly encourage FHFA to be aware of the impact of FHA on the market and to avoid, while fulfilling its statutory mandates, actions which drive business to FHA where private capital is ready and willing to assume the risk.

Question 7: Is it desirable for the Enterprises to (a) charge higher g-fees on high credit score/low LTV loans if it causes these loans to be insured/securitized through PLS or (b) held on depository balance sheets, rather than guaranteed by the Enterprises?

Within the established loan limits, GSEs pricing should align to the underlying risk of the loans they back and be consistent with the requirements of the TCCA.

Question 8: What approaches or alternatives should FHFA consider in balancing increased use of risk-based pricing with the HERA mission requirements of (1) liquid national housing markets and (2) acceptability of lower returns on loans made for low- and moderate-income housing?

With regard to low-and moderate-income borrowers, the most important change to be made is for g-fees to fully reflect the risk mitigation benefits of MI from a well-capitalized MI company. The justification for full recognition is based on the new PMIERs requirements to ensure the claims paying ability of MI providers meeting the standards, and new MI master policies.

With regard to the broader question of the use of risk based pricing by the GSEs, it's important to recognize that U.S. residential mortgage credit risk is highly complex and multi-faceted. As such, risk-based pricing can be implemented in a wide variety of frameworks, with one extreme being pricing for every aspect of borrower and loan credit risk characteristic, geography, prepayment behavior and national and regional economic conditions. Such an approach would produce a very reactive pricing framework that would be subject to the vagaries of the underlying economic drivers. This approach would also expose the GSEs to very substantial model risk, as more highly differentiated pricing places great reliance on model specifications and the resulting differentiation in risk perceived by the model, real or not. In the alternative is a very "flat" pricing framework which charges a single, average price. Such a regime misses critically important risk signals, which are lost in the average. For example, not differentiating price on LTV fails to signal to borrowers the benefits of saving for a larger down payment, if possible within the family's budget. Therefore, we conclude that a sensible risk-based pricing paradigm should seek an appropriate balance that ensures that enduring, material risk drivers are reflected in pricing to the market. Risk drivers related to borrower creditworthiness, such as LTV and credit score, have proven themselves to be consistent differentiators of credit performance and reflecting them in pricing signals the market appropriately with regard to the cost of mortgage credit.

The current GSE pricing paradigm, which has been in place for an extended period, seems to strike such a reasonable balance and relies primarily on borrower and loan characteristic risk drivers. The current GSE regime has had no adverse impact on maintaining a liquid national housing market through the GSEs' TBA securities. However, more extreme risk-based pricing might have adverse impacts on liquidity and, therefore, should be very carefully considered. Further, the impact of more extreme risk-based pricing regimes might also fall more heavily on low and moderate-income borrowers depending on how the models are specified and the g-fees set to the market. Therefore, some moderation in risk-based pricing is consistent with both safety and soundness to limit model risk, and ensuring credit access and affordability by low and moderate income borrowers.

Question 10: Should risk-based pricing be uniform across the Enterprises or should each Enterprise manage its own pricing?

Given the requirements of TCCA for GSE pricing of g-fees at levels equivalent to "fully private regulated institutions" and their current status as entities in conservatorship, we believe uniform pricing makes the most sense. There would seem to be no rationale to support taxpayers accepting differing returns for the same credit risks assumed by one GSE versus another.

Exhibit 3: Essent's Comments on FHFA's Proposed PMIERs, Dated September 8, 2014

[Begins on the following page]

Essent Guaranty, Inc.
Two Radnor Corporate Center
100 Matsonford Road
Radnor, PA 19087

www.essent.us

September 8, 2014

By electronic delivery to: www.fhfa.gov/open-for-comment-or-input

The Federal Housing Finance Agency
Constitution Center
400 7th Street SW
Washington DC 20014
Attn: Mortgage Insurance Eligibility Project

Re: Draft Revised Private Mortgage Insurer Eligibility Requirements - Request for Input

Ladies and Gentlemen,

Essent Guaranty, Inc. ("Essent") is a nationwide provider of private mortgage insurance ("MI"), and an approved insurer for both Fannie Mae and Freddie Mac (collectively, the "Enterprises" or "GSEs") under their respective existing eligibility requirements. We appreciate that the Federal Housing Finance Agency ("FHFA") is requesting input on the draft revised Private Mortgage Insurer Eligibility Requirements ("PMIERs"). We thank the FHFA and the GSEs for the opportunities afforded to provide input and we are pleased to offer our written comments, which we provide in three parts: first, an executive summary of Essent's key comments and recommendations, second, a more detailed discussion and rationale for our key comments and recommendations and third, responses to certain of the specific questions posed in the FHFA's July 10, 2014 Overview of the Draft Revised PMIERs.

Executive Summary of Essent's Key Comments

The PMIERs are an important and significant update to GSE eligibility requirements. The fundamental goal of the PMIERs should be to set consistent and transparent standards that when enforced assure safe and sound MI counterparties whose coverage reliably protects taxpayers and other policyholders. The significant advances made by the PMIERs are a natural and necessary evolution in the industry toward stronger and more risk-sensitive assessments of insured portfolios and the capital needed to stand behind the coverage. MI companies that comply with the PMIERs as proposed would be strong financial counterparties with the capacity to fully pay claims in a stressful economic environment.

We do not believe the PMIERs will result in adverse impacts on credit access and affordability. Rather, financially strong MI best aligns to the goals of an affordable, accessible and stable housing finance system with a significant role for private capital. Finalization of prudent standards as reflected in the PMIERs may actually serve to lower the cost of mortgage credit by allowing the GSEs to fully recognize the risk-mitigating value of MI in GSE guarantee fees ("g-fees," see Essent's response to FHFA's Request for Input on GSE G-fees dated September 8th, 2014, included in the Appendix to this letter). We propose that the fundamental test for whether or not the PMIERs

establish an appropriate level of financial strength is that the full risk-mitigating benefit of MI coverage obtained by lenders and placed on loans before the GSEs issue their guarantee is reflected in appropriately lower GSE g-fees.

In short, we urge expeditious adoption of the PMIERs without material change for the reasons highlighted below.

Key Conclusions from Essent's Evaluation of the PMIERs:

- The PMIERs' framework appropriately focuses on an MI company having a sufficient level of high quality, liquid assets available on-hand to pay claims. [1]

- The PMIERs make a number of other prudential advances that mitigate against excessive leverage and risk, such as requiring consolidation of the risk and assets of certain affiliated reinsurers to ensure a more complete assessment of financial strength.

- The PMIERs are a significant enhancement to prior standards, implementing a sound, risk-sensitive methodology for required assets in relation to the claim development likelihood of an MI company's risk-in-force.[2]

- The effective upfront required assets under the PMIERs are prudent and align with Essent's methodologies for assessing economic capital.[3] Generally, post-crisis vintage insured MI loans that are not delinquent would be subject to required assets in the range of approximately 6.0% to 6.7%, equivalent to traditional MI risk-to-capital ("RTC") ratios in the range of 16.7:1 to 15:1.[4] Essent's consolidated RTC ratio at the end of the second quarter of 2014 was 16.2:1.[5]

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[1] The available asset requirements of the PMIERs are structurally similar for non-delinquent loans to the traditional MI requirement to hold a certain amount of statutory capital in relation to an MI's risk-in-force ("RIF") on non-delinquent loans. In addition, the available assets required in the PMIERs for delinquent loans is structurally similar to the requirement that MI companies have to establish loan loss reserves for delinquent loans. However, the PMIERs requirements disallow some or all of certain assets that are of low quality, volatile in value or illiquid and therefore not readily available to pay claims. The PMIERs also disallow counting unearned premium reserves ("UPR") in available assets, mirroring their exclusion from statutory capital.

[2] For an MI company whose statutory assets are substantially all considered "available assets" under the PMIERs, the traditional measurement of MI financial strength expressed as a ratio of risk-in-force (RIF) to capital (the "RTC ratio") is materially interchangeable with the PMIERs ratio of required assets to risk (the "required asset" ratio).

[3] The term "economic capital" as used herein refers to the widely understood concept of holding capital to protect against unexpected losses. Given the long-lived and long-tailed nature of mortgage credit risk, unexpected losses on mortgage insurance contracts can be large. Economic capital is the level of capital sufficient to fully pay claims under conditions of economic stress.

[4] For ease of reference, for an MI company whose statutory assets are substantially all considered "available assets" under the PMIERs, RTC ratios of 15:1, 16:1, 20:1 and 25:1 translate into PMIERs required asset ratios of 6.67%, 6.25%, 5% and 4% respectively.

[5] Essent's began writing business in 2010 and as such has no exposure to crisis-era vintages. The PMIERs establish a separate required asset grid for 2009 and later vintage RIF.

- Insofar as the required asset levels produced by the PMIERs are consistent with how Essent has already been capitalizing our business and pricing new insurance, Essent expects returns on similar new business under PMIERs asset requirements will remain adequate and meet our target returns.

- Given the adequacy of returns on new business, Essent does not find a rationale to conclude that there should or will be an adverse impact on MI pricing or access to credit by the consumers served by MI. In fact, well-capitalized MI may enable lower costs and expanded access to mortgage credit.

- Recommendations by other parties to (1) recognize future premiums or (2) include seasoning are not necessary or advisable and should not be adopted at this time. We find that such changes undermine the integrity of the standards, can add needless complexity and reduce transparency and create an unnecessary risk of material delay in the adoption of standards. We recommend these (or any other material changes to the PMIERs framework) be deferred for more careful evaluation at a later time.

Key Essent Recommendations*:*

- The PMIERs can and should be adopted without material change. Efforts to make material changes to the framework are not necessary and risk needless delay.

- Two targeted refinements to the PMIERs would better align required assets to risk for current business and for potential future changes in the profile of insured business. These changes would not adversely impact the rigor of the standards necessary to ensure robust claims paying capacity and both are readily incorporated within the existing PMIERs framework.

    1. Finer gradations by credit score of 20 point increments in the required assets grids for 2009 and later vintage risk-in-force; and,

    2. Adoption of a required asset floor of 3% (versus the 5.6% developed for loans with loan-to-value (“LTVs”) of above 80%) for MI insured loans with LTVs of 80% or less.

- Once adopted, the PMIERs framework should be left in place for an extended period to allow the industry to come into compliance and to validate the efficacy of the new standards. Future changes should be subject to a sound governance framework that includes adequate opportunity for notice and comment and other process controls as may be established by the FHFA.

- The requirement for MI companies to have at least one rating should be strengthened such that the rating must be an insurer financial strength rating of at least “investment grade” at the end of the PMIERs compliance period.

- Section 310 of the PMIERs related to loss mitigation delegations should be revised, removing the language related to requirements for full delegation. We believe this language does not belong in the PMIERs, whose focus should be counterparty safety and soundness. While

current delegations are not affected by such a change as the crisis-era backlog of delinquent loans is resolved, we recommend further discussions between FHFA, GSEs and the MI industry as to appropriate revisions to the framework for loss mitigation, supported by the inclusion of loss mitigation metrics and thresholds as part of the PMIERs Operational Scorecard for Approved Insurers.

Detailed Discussion of Essent's Key Findings

➢ **The proposed framework appropriately focuses on high quality liquid assets available on-hand to pay claims and produces sound economic results for new insurance written.** The PMIERS required asset levels for post-crisis era MI risk are generally consistent with Essent's own analysis of economic capital and, therefore, are in line with the capital levels Essent has been using to capitalize the company, assess risk and price new business. Overall, we believe the required asset levels are sound and appropriate for the risk and ensure robust claims paying capacity under conditions of severe financial stress for companies that meet the financial requirements.

The requirements for available assets to be counted in order to meet the level of required assets are also sound, and help ensure that MI companies hold sufficient, high quality and readily liquid assets to pay claims in times of stress. The requirements properly focus on high quality assets, the liquidity of assets to be available to pay claims and the volatility in the value of assets. The requirements also make a number of additional, prudential advances which mitigate against excessive leverage and risk, such as requiring consolidation of the risk and assets of certain affiliated reinsurers to ensure a more complete assessment of financial strength. Consistent with their treatment for statutory capital, unearned premium reserves ("UPR") are deducted from the calculation of available assets, which prudently avoids creating a PMIERs available asset arbitrage in favor of single premium products.

Since the PMIERs were released for public input in July, much focus has been placed on the required asset levels produced by the PMIERs and whether or not they are reasonable. Traditionally, many have looked to the prevailing state regulatory standard of 25:1 RTC as the upper bound of MI leverage, and intuition has been that future standards for prudently underwritten new business would certainly be below 25:1 and fall somewhere in the range of 15:1 to 18:1. While the PMIERs use a required asset test as opposed to the traditional MI RTC ratio, for an MI company whose statutory assets are substantially all "available assets" under the PMIERs, the traditional MI RTC ratio is effectively interchangeable with the PMIERs ratio of required assets to risk. For reference, RTC ratios of 15:1, 16:1, 20:1 and 25:1 translate into a PMIERs required asset ratio of 6.67%, 6.25%, 5% and 4% respectively.

Under the PMIERs, post-crisis vintage insured MI loans that are not delinquent would generally be subject to required assets in the range of approximately 6.0% to 6.7% of risk, equivalent to traditional MI RTC ratios in the range of 16.7:1 to 15:1. To test whether these required levels are reasonable, we utilized several methodologies, including the Basel Advanced Bank Capital Formula ("A-IRB"). Shown below (and in further detail in the **Appendix A** of this letter), the A-IRB formula when applied to newly insured MI risk produces requirements that are very much in line with the requirements of the PMIERs and Essent's own stress testing methodologies for assessing

economic capital. We further note that the A-IRB formula does not include any future premium income.

Basel Advanced Bank Capital Formula - Illustrative Values for Mortgage Insurance Capital Assessment (see Appendix for details)

Institution-Determined Values	Notes	Example 1	Example 2	Example 3	Example 4
Claim Rate on New Business	Through-cycle average	1.50%	2.00%	2.50%	3.00%
Long Run Expected Life	Through-cycle average	4.00 yrs	4.50 yrs	5.00 yrs	5.50 yrs
LGD (% of UPB)	Contractual MI coverage	25.0%	25.0%	25.0%	25.0%
Downturn LGD Multiple (% LGD)	Stress experience	110%	110%	110%	110%
Final Credit Capital Calculations	**Notes**	**Values**	**Values**	**Values**	**Values**
Conditional Annualized Loss	Basel Formula Adjusted	1.50%	1.70%	1.85%	1.97%
Expected Annualized Loss	Frequency x Severity	0.10%	0.12%	0.14%	0.15%
Capital Requirement: % UPB	**Unexpected Loss: UPB Basis**	**1.40%**	**1.58%**	**1.71%**	**1.82%**
Capital Requirement: % RIF	**Unexpected Loss: RIF Basis**	**5.59%**	**6.31%**	**6.86%**	**7.29%**
Capital Requirement: Leverage Ratio	**RIF ÷ Capital Requirement**	**17.9:1**	**15.8:1**	**14.6:1**	**13.7:1**

➢ **The returns on new business remain adequate and well-capitalized MI should preserve and enhance affordability and consumer credit access.** Essent's analysis finds that expected returns on new business remain adequate and meet our target returns. As a result, Essent does not see an adverse impact to affordability and consumers' access to credit by the adoption of the PMIERs as proposed. In fact, it is possible that finalization of strong MI financial standards for MI companies as reflected in the PMIERs can lower the costs of mortgage credit by allowing the GSEs to fully recognize the risk-mitigating value of MI in GSE g-fees (see Essent's response to FHFA's Request for Input on GSE G-fees dated September 8th, 2014, included in the Appendix hereto). We propose that the fundamental test for whether or not the PMIERs are set at an appropriate level of financial strength is that the full risk-mitigating benefit of MI coverage obtained by lenders and placed on loans before the GSEs issue their guarantee is reflected in appropriately lower GSE g-fees.

➢ **Recommendations to (1) recognize future premiums, or (2) include seasoning should not be adopted at this time.** Our findings with regard to each of these widely-discussed potential revisions to the PMIERs framework identify material adverse impacts such as undermining the integrity of the standards, adding needless complexity and reducing transparency, and risking significant delay. We recommend these (or any other material changes to the framework) be deferred for more careful evaluation at a later time. We discuss each of these potential framework revisions below. We also comment below on the PMIERs required assets for delinquent loans, an aspect of the proposed standards that seems to have not been well-understood.

– *Premium Income as an Available Asset*

There are a number of valid methodologies for developing capital requirements for mortgages and many do not include recognition of premium income. For example, as we have shown in our discussion above with regard to assessing the required asset levels produced by the PMIERs, the Basel A-IRB capital supervisory formula estimates capital requirements for mortgage credit risk without any consideration of premium income. Similarly, the PMIERs asset requirements were constructed without inclusion of future premium income and (as we note above) produce

required asset levels consistent with Essent's economic capital analysis as well as the A-IRB formula.

Given the development of the PMIERs standard in a manner intended not to include premium income, we find that modification of the PMIERs to include even modest amounts of estimated premium income (e.g., 1-2 years) results in leverage that is inappropriately high. Indeed, the potential resulting leverage could exceed the minimum required asset floor of 5.6% (i.e., 18:1 RTC) which the PMIERs established to ensure a prudential level of minimum assets for above 80% LTV risk, and might result in leverage significantly above the current 25:1 RTC maximum under governing state law. The table below makes it very transparent as to why these results occur and would be imprudent absent other changes to the framework. Given an initial assumed required asset level of 6.67% on risk-in-force (i.e., 15:1 RTC), one year of MI premiums would be approximately 2.2% of risk-in-force, or fully one third of the 6.67% requirement. Allowing future premiums to fill the 6.67% requirement quickly results in dramatically lower amounts of MI capital being held upfront. As a result, the RTC ratio (which is measured based on the upfront capital and has never included future premiums) increases dramatically and quickly to levels that can be quickly identified as not prudent.

Sensitivity Analysis of Effective Risk-to-Capital from Allowing Future Premiums within PMIERs Asset Requirements

Proposed Premium Renewal Credit	Premium Contribution (% RIF)	Net Upfront Asset Requirement (% RIF)	Premium Contribution (% Total Required)	Risk-To-Capital (RTC)	Risk-To-Capital Comments
None	-	6.67%	-	15.0-to-1	Current PMIERs, Prudent RTC
1 year	2.20%	4.47%	33%	22.4-to-1	Elevated RTC
2 years	4.40%	2.27%	66%	44.1-to-1	Exceeds state 25:1 limit
3 years	6.60%	0.07%	99%	1428.6-to-1	Effectively 100% self-funded

Note: premium contribution level assumes average annual premium rate of 0.55% UPB with coverage of 25% yielding effective rate-on-line of 2.20%.

Clearly, the simple inclusion of premiums into the PMIERs framework would need to be offset by inclusion of other offsetting future cash flows, such as operating expenses and federal income taxes and possible increases in the rigor of the applied stress test. In general, the arguments for recognition of future premiums or other future financial flows (e.g., recognition of unearned premium reserves, investment income, operating expenses and taxes), push the PMIERs toward a "sources and uses" of funds framework. While a "sources and uses" framework is a valid method of assessing capital adequacy, there are equally valid alternatives such as the FHFA and the Enterprises have established with the PMIERs framework. Sound capital requirements can be developed with or without the inclusion of future premiums, and we concur with the choice of a framework that appropriately values the benefits of simplicity and transparency while assuring the resulting capital requirements are well -confirmed. Given that the overall level of PMIERS required assets appears appropriate to us as validated by cross-testing with well-regarded methodologies, we see no need to change the proposed framework materially now to include future premium income, as this would result in having to make the many additional material changes necessary to develop a full "sources and uses" methodology.

Some who have proposed inclusion of premiums into the PMIERs framework have suggested artificial limitations on the amount of the premium income to be included (e.g., future premiums

limited to only one third of total available assets or only two years of estimated premiums despite an average MI contract life in excess of four years). Recommendations for such arbitrary limitations are likely borne out of a recognition that unrestricted inclusion of premiums results in plainly imprudent leverage. These approaches cause concern for two reasons. First, there is no sound justification for the amount of premium not included and therefore the resulting level of required upfront assets is completely arbitrary. Second, if an arbitrary minimum amount of upfront capital is imposed to mitigate against excessive amounts of capital being provided by future premiums, such an arbitrary cap would likely become the binding level of capital for many risks. The net result would be to push the framework back toward the prevailing "flat-capital" framework and away from the critically important advance inherent in the risk-based assessments reflected in the PMIERs. The risk-based aspect of the PMIER framework as proposed is one of its most important features and will bring much needed discipline to the evolution of MI portfolios.

– *Seasoning*

An additional common critique of the PMIERs has been the lack of an observable loan seasoning component applicable to the required assets for 2009 and later vintage risk-in-force. We understand that the required asset grids for 2009 and later business do reflect some seasoning effects and we find the overall asset requirements applicable to such loans to be appropriate. As such, further changes with regard to seasoning are not necessary and are likely to add needless complexity to the requirements and introduce substantial model risk.

Contrary to assertions by some, we do not find it unambiguously clear that default risk declines uniformly with loan age. Historical experience and mortgage research literature supports a non-monotonic loss development whereby – all else equal – the default risk of an active, current loan is observed to increase during the first few years of seasoning and generally does not decrease until much later (e.g., year five and beyond). Further, the impact of seasoning is highly dependent upon the path of home values, thus proper incorporation of an accurate seasoning factor would require a specification of forward expectations for home prices. A salubrious future home price assumption will tend to reduce the capital required as the portfolio ages, whereas a stressful assumption will have the opposite effect. The average seasoning impact that we understand underlies the PMIERs grid development covered a mixture of declining and recovering housing markets, which leads us to conclude that the "averaged" seasoning embedded in the capital grids is an appropriate approach to the framework.

Broadly speaking, we urge caution with regard to seasoning or any other well-intended recommendation for "refinements" to the PMIERs to include factors that may legitimately have some impact on risk but are not currently included in the PMIERs framework as proposed. The U.S. mortgage credit risk contract is extremely complex, and borrower performance is influenced by multiple factors and underlying drivers that influence the initial level of risk and how that risk changes over time. Efforts to dis-entangle even a modest number of these numerous factors may result in an overly complex and potentially unpredictable capital framework. Such a level of complexity is not warranted for a regulatory capital framework that should reflect enduring drivers of risk (such as LTV and credit score) and needs to be compatible with the practical aspects of economic capital management. There are certainly targeted aspects of the PMIERs framework that could be refined to better align capital to risk – such as more granularity in the FICO bands utilized in the 2009 and later required asset grid for current loans. Such adjustments

can be implemented easily because they are simply refinements to the existing framework that can be implemented without compromising its transparency and simplicity. On the other hand, incorporating seasoning or other changes not already explicitly built into the framework will cause unnecessary delay when the PMIERs already produce sound results and may at best lead to only marginal improvements in safety and soundness at the cost of an unwieldy and less transparent framework subject to significant model risk.

– *Delinquent Loan Asset Requirements*

Finally, with regard to the PMIERs we have noted that some commenters have misunderstood the requirement to hold available assets for delinquent loans and the impact of such a requirement versus current MI capital. We find that the delinquent loan factors are quite consistent structurally with the current framework for MI capital that requires an MI company to hold loan loss reserves for delinquent loans. Under the PMIERs, the assets associated with an MI's loan loss reserves count toward available assets, therefore at least a portion of the PMIERs available asset requirement for delinquent loans is met by an MI company's already established loan loss reserves. Because the PMIERs required asset framework is based on a stressful economic environment, and loan loss reserves are not, the PMIERs required assets for delinquent loans are likely to exceed loan loss reserves under normal economic environments. Other factors that will affect the magnitude of the difference include the performance of the insured portfolio, the timeliness of claim payment and the rescission practices of the MI company.

The PMIERs delinquent loan required assets will rise, logically, as a portfolio seasons and loans become delinquent. This is similar to current regime where loan loss reserves will rise as delinquent loans rise, and similarly require more capital over time. This "pro-cyclicality" of loan loss reserves is well known, and in fact loan loss reserves may be more pro-cyclical than the PMIERs required assets for delinquent loans through the cycle given the fixed per loan required asset factors in the PMIERs grid.

Overall, we find that the PMIERs proposed required asset factors for delinquent loans are generally appropriate and consistent with the stress-test framework of the PMIERs. Conservative factors help ensure that MI companies have sufficient assets on hand to pay claims on delinquent loans, an important protection for policyholders and lenders who have endured the economic consequences of non-payment of MI claims in recent years. Lower risk portfolios supported by business practices that result in timely payment of claims and limited rescissions and with appropriate levels of loan loss reserves will experience a more modest impact from the PMIERs required assets for delinquent loans.

Essent's Recommendations for Refinement of the PMIERs

➢ **Targeted refinements to the existing PMIERs required asset factors would better align required assets to risk without compromise to the fundamental integrity of the standards or delay.** We propose modest refinements to the PMIERs required asset factors that would preserve the financial integrity of the requirements yet advance the counterparty risk management objective of aligning required assets to risk for current business and if the profile of future business shifts. These proposed changes are consistent with the basic structure of the existing PMIERs framework and should be readily implementable. Proposed changes:

1. Finer gradations in the required asset grids for 2009 and later vintages by using 20 point FICO increments. Essent analysis finds that for FICOs below 740, each 20 point reduction in FICO has a meaningful impact on risk and extends at least down to FICOs of 620. This change can be implemented without material impact on the overall asset requirements for performing loans as it simply reflects a more refined allocation of the total asset levels already inherent in the proposed grids.

2. For MI insured loans with LTVs of 80% or less, the required asset floor of 5.6% should be revised to 3%. The overall required asset floor would be a blended floor based on the mix of above 80% and below 80% insured risk-in-force. This change would adjust the floor level of required assets to reflect the lower risk of loans with LTVs less than or equal to 80%. This change should be made to ensure that MI can serve as broad a segment of the mortgage market as possible and not face needless barriers in the PMIERs which do not reflect actual risk. In fact, MI companies would be stronger and safer counterparties if lower risk loans with LTVs of 80% or less were part of the insured portfolios.

➢ **The PMIERs can be adopted largely as proposed and material changes create risk to timely implementation.** As we have noted in our assessment of the PMIERs, common critiques of the PMIERs requirements do not provide a compelling rationale to revise the PMIERs' framework. As proposed the PMIERs represent a very significant advance over current requirements and produces sound results. We are concerned that many proposed changes would have the effect of watering down the PMIERs requirements or would change their basic nature by increasing complexity, reducing transparency or adding assumptions that are subjective and difficult to validate. As such, material changes are not necessary and risk needless delay in finalizing standards and enforcing compliance, which is vital to market participants.

- If changes to premium recognition are contemplated, it is critical that unearned single premiums not be given more asset recognition than monthly premium products so as not to create a regulatory arbitrage incentive toward single premium products as opposed to monthly premium products due to the close resemblance in economics between the two premium streams.

- If material changes are made to the framework, the changes should be re-proposed and resubmitted for public input. A materially different framework should not be finalized without an appropriate opportunity for industry participants and the public to comment on material revisions.

➢ **Once final, the required asset grids should be held stable for an extended implementation and validation period.** The risk-sensitive capital approach envisioned under the PMIERs is a significant improvement over the prevailing, risk-insensitive and more leveraged 25:1 RTC capital paradigm that otherwise governs MI companies. We understand the GSEs plan to update the PMIERs risk-based required asset grids in the future, for example as the C-CAR scenarios are revised. While we recognize that such changes could be useful, we advocate that once finalized the grids should not be revised for an extended period of time to give the industry time to implement and operate the business within the new standards and an opportunity for FHFA and the GSEs to validate the effectiveness of the framework in actual operation. In addition, we note that the PMIERs proposes an extended two-year period from final publication

for companies to come into compliance, and as such it would make little sense to make changes to the grids during the initial compliance period or for one to two years after the end of the compliance period. We believe the PMIERs as proposed reflect very prudent requirements, and are sufficiently conservative and risk-sensitive (and with minor adjustments as proposed above can be made even more risk-sensitive) to yield robust, risk-based asset requirements going forward with little counterparty risk to the GSEs if left unchanged for the foreseeable future.

➢ **The process for revising the standards requires a robust governance framework.** We recognize the need for the GSEs and FHFA to retain the right to revise the PMIERs. However, changing the PMIERs financial requirements has a very significant impact on the mortgage market. Given the strong standards proposed, we see little need for further change for the foreseeable future. However, when changes are necessary we recommend a strong governance process as evidenced by the process utilized with the current proposed PMIERs. Prior to changes being proposed at a minimum there should be review by FHFA and oversight of the change process. In addition sound governance should include adequate public notice and comment, and a careful assessment of the impact of revised standards on the industry as is commonly done in banking regulation. Revisions to the PMIERs should always establish a reasonable phase-in period for companies in full compliance with prior standards to meet revised standards.

➢ **Inclusion of an investment grade rating requirement complements and strengthens the PMIERs**. We urge the inclusion in the PMIERs of a requirement that approved insurers must have an investment grade insurer financial strength rating from at least one rating agency by the end of the two-year PMIERs compliance period in order to continue to be eligible to write new insurance for the GSEs. We struggle to see how taxpayers are considered well-protected when obtaining insurance from companies without at least an investment grade rating. The use of a rating requirement, as a complement to the GSEs' own financial standards, provides the GSEs and FHFA with an additional review and validation of MI counterparty strength and claims paying ability to backstop the PMIERs other requirements. We do not believe such a requirement would be onerous and could be put forward for separate comment while the remainder of the PMIERs can be finalized for implementation.

➢ **MIs have a contractual right to a role in loss mitigation and FHFA should not allow the PMIERs to mandate delegation of approval rights or enforce this requirement through GSE g-fee surcharges.** Full delegation of an MI company's authority to approve short sales and deeds-in-lieu of foreclosure was requested by FHFA and the GSE as necessary response to the housing crisis and the resulting large numbers of defaulted loans. However, as the crisis is resolved we believe for well-underwritten loans and under normal economic conditions, there is a very high likelihood that the economic interests of the GSEs and of MI companies will differ because the MI bears the first loss and is more likely to incur a disproportionate share, if not the entire, loss. Full delegation from the first-loss insurer to the second loss insured suffers from an inherent potential conflict of interest as the economic interests of the parties may not be aligned, especially as the housing economy recovers and the MI contracts start increasingly absorbing a larger share of the losses on the defaulted loans. As such, full delegation may be imprudent absent other mitigating controls. In addition, the lack of involvement by MI companies deprives the system a significant intended benefit stemming from the oversight of third parties with private capital at risk.

We believe that the provisions of Section 310 in the PMIERs stating the full delegations should be provided and granting the GSEs the right to differentiate g-fees depending on MI delegation should be withdrawn. Full delegation is not a fundamental question of counterparty safety and soundness, which is the focus and intent of the PMIERs. Rather, the provision is an effort to extend into the PMIERs an important point of business and policy difference which merits an appropriate resolution. We strongly urge FHFA to remove the language in Section 310 stating that MI companies should provide a full delegation and allowing for g-fee adjustments on loans insured by an MI company that does not provide a full delegation. Instead, we recommend that the FHFA and the GSEs engage with the MI industry in further discussions with regard to a framework for loss mitigation workout approval or delegation that strikes a more appropriate balance for the system as the crisis-era backlog of loans is resolved. An Approved Insurer's cooperation in this regard should be managed as an operational aspect of our business, subject to evaluation in the Operational Scorecard process being established under the PMIERs. We look forward to working with FHFA and the GSEs on such a resolution that would be effective for MIs, GSEs and servicers.

Conclusion

Again, we appreciate the opportunity to provide input on these critically important standards for MI companies and their policyholders. We urge their timely adoption substantially as proposed because they represent a significant step forward by establishing strong, risk-sensitive standards and insisting upon high quality, liquid assets to be held upfront to ensure claims paying capacity. Once adopted, companies that meet these financial and prudential requirements will be strong counterparties for the GSEs and other policyholders, enabling the market to have added confidence on the value of MI. These requirements have been a significant undertaking by FHFA and the GSEs, and we commend you for the effort and progress.

Sincerely,

Adolfo F. Marzol
Executive Vice President

Appendix

A: Basel A-IRB Test Applied to MI
B: Responses to Questions Posed by FHFA in its Overview
C: Essent's Letter in Response to FHFA's Request for Input on GSE G-fees

Appendix A – Basel A-IRB Detailed Application to MI Risk

Basel Advanced Bank Capital Formula - Illustrative Values for Mortgage Insurance Capital Assessment

Institution-Determined Values	Notes	Example 1	Example 2	Example 3	Example 4
A) Claim Rate on New Business	Through-cycle average	1.50%	2.00%	2.50%	3.00%
B) Long Run Expected Life	Through-cycle average	4.00 yrs	4.50 yrs	5.00 yrs	5.50 yrs
C) LGD (% of UPB)	Contractual MI coverage	25.0%	25.0%	25.0%	25.0%
D) Downturn LGD Multiple (% LGD)	Stress experience	110%	110%	110%	110%
Basel Formula Inputs	**Notes**	**Values**	**Values**	**Values**	**Values**
E) Average PD	= A ÷ B, i.e. annualized	0.38%	0.44%	0.50%	0.55%
F) LGD Parameter	= C x D	27.50%	27.50%	27.50%	27.50%
G) Confidence Level	Per Basel BIS documentation	99.9%	99.9%	99.9%	99.9%
H) "R" Systemic Correlation	Per Basel BIS documentation	15.0%	15.0%	15.0%	15.0%
I) "M" Effective Maturity	Per Basel BIS documentation	1.0 yrs	1.0 yrs	1.0 yrs	1.0 yrs
Intermediate Basel Formula Calculations	**Notes**	**Values**	**Values**	**Values**	**Values**
J) PDZ	= NORMSINV(E)	-2.674	-2.616	-2.576	-2.546
K) W1	= (1 / (1 - H)) ^ 0.5	1.085	1.085	1.085	1.085
L) PDZ*W1	= J x K	-2.900	-2.838	-2.794	-2.761
M) VaRZ	= NORMSINV(G)	3.090	3.090	3.090	3.090
N) W2	= (H / (1 - H)) ^ 0.5	0.420	0.420	0.420	0.420
O) VaRZ*W2	= N x M	1.298	1.298	1.298	1.298
P) ZPDadj	= L + O	-1.602	-1.540	-1.496	-1.463
Q) PDadj	= NORMSDIST(P)	5.46%	6.18%	6.74%	7.17%
R) M-adj Intercept	Per Basel BIS documentation	0.11852	0.11852	0.11852	0.11852
S) M-adj Slope	Per Basel BIS documentation	0.05478	0.05478	0.05478	0.05478
T) M-adj "b"	= (R - S x LN (E)) ^ 2	0.03581	0.03581	0.03581	0.03581
U) Maturity Adjustment	= (1 + (I - 2.5) x T) / (1 - 1.5 x T)	1.0000	1.0000	1.0000	1.0000
Final Credit Capital Calculations	**Notes**	**Values**	**Values**	**Values**	**Values**
V) Conditional Annualized Loss	= Q x F	1.50%	1.70%	1.85%	1.97%
W) Expected Annualized Loss	= E x F	0.10%	0.12%	0.14%	0.15%
X) Capital Requirement: % UPB)	**= (V - W) x U**	**1.40%**	**1.58%**	**1.71%**	**1.82%**
Y) Capital Requirement: % RIF	**= X ÷ C**	**5.59%**	**6.31%**	**6.86%**	**7.29%**
Z) Capital Requirement: Leverage Ratio	**= C ÷ X**	**17.9:1**	**15.8:1**	**14.6:1**	**13.7:1**

<u>Appendix B – Responses to Selected Questions posed by FHFA in the PMIERs Overview</u>

A. Business Requirements

1. Scope of Business:

a. How can the PMIERs ensure that Approved Insurers have long-term access to staff, services and technology that meet their operational needs for administering their insurance book of business?

<u>Response</u>: GSE operational audits have provided ample opportunity to test compliance with the prior eligibility rules and could be re-calibrated to focus on PMIER compliance risks.

b. How can the PMIERs ensure that potential losses from insuring high-risk loan concentrations do not jeopardize an Approved Insurer's financial ability to pay claims on its lower risk portfolio?

<u>Response</u>: The PMIERs requirements provide for very robust risk-based asset requirements, minimum levels of required assets regardless of risk and ensure that available assets are of high quality and liquidity to pay claims. As such, the financial requirements alone provide strong assurance about a PMIERs compliant MI company's capacity to pay claims. In addition, the extensive oversight conducted by the GSEs including receipt of loan level data from every MI company, quarterly business reviews and on-site audits should provide the GSEs extraordinary transparency into MI risk and risk management practices. There is no other counterparty that the GSEs do business with that is subject to this level of standards and oversight, which should give the GSEs exceptional confidence in their MI partners, post-adoption of final PMIERs.

c. Should Approved Insurers have separately funded affiliates for insuring higher-risk products?

<u>Response</u>: No. We are unclear what is meant by "higher risk" business in this question. We note in our response to 1b. above that the PMIERs risk based asset requirements and other oversight should give the GSEs a very high level of comfort in their MI counterparties. In general, there is also a significant reduction of risk from the beneficial impact of diversification of risk within a credit risk bearing entity. If the question relates to non-GSE loans, the risks may not necessarily be higher than GSE risks.

2. Should the adequacy of each Approved Insurer's risk-adjusted rates of return be measured? If so, what would be the appropriate calculation method for this measure?

<u>Response</u>: The PMIERs required asset levels are very prudent and are not based on future premiums or returns. As such, we see no need to measure the adequacy of risk-adjusted rates of return. We believe prudent capital standards that are appropriately enforced will serve to provide necessary risk and capital discipline and that returns will be set based on competitive market factors such as the returns necessary to attract and retain capital in the industry.

3. If the Enterprises, in the interest of establishing strong counterparty financial requirements, expect an Approved Insurer to maintain "adequate" risk-adjusted rates of return for New Insurance Written (NIW), what might be benchmarks for the Enterprises to establish a reasonable range of such expected returns? Should the benchmark also be inclusive of the Approved Insurer's entire portfolio of Insurance in Force (IIF), or only a defined portion?

Response: By requiring prudent asset levels on a risk adjusted basis, the PMIERs create strong incentives for risk discipline which includes adequate pricing for risk. However, the overall level of return should be set by market forces such as the return requirements of investors providing capital to the private MI industry and competitive forces within the industry. The PMIERs should not establish benchmarks with regard to measurement of rates of returns, and rather the focus after implementation of the PMIERs should be ensuring compliance with the requirements.

4. What counterparty risks might be raised by an Approved Insurer maintaining inadequate risk-adjusted rates of return on capital across its expected business profile?

Response: The returns that might be judged as "inadequate" may well be sufficient in a competitive market. Over time, if expected returns are inadequate to attract capital then adjustments will occur in a competitive market through changes to pricing and risk. Great care should be taken in interfering with the overall level of pricing in the MI market. We do believe that there is a meaningful counterparty risk that an Approved Insurer would increase writing single premium products that are discounted to monthlies (i.e., have lower risk-adjusted rates of return) if unearned premium reserves (UPR) were to be recognized as an Available Asset. We strongly urge that UPR not be given recognition as an available asset, and that any recognition not advantage single premium products over monthly premium products.

5. Should an Approved Insurer be required to validate a third-party AUS prior to using the recommendations from these systems? If so, what type of analysis would be appropriate to sufficiently validate that the credit decisions from the AUS are in line with the Approved Insurer*'s* credit underwriting requirements?

Response: An Approved Insurer should always maintain diligence in its risk management processes. Any automated system, and on-going enhancements to such a system, to which an Approved Insurer may delegate its credit authority must undergo a thorough evaluation. Given the uncertainties regarding the direction of technology, the PMIERs should not be prescriptive, but should ensure the GSEs review an Approved Insurer's risk management staff and processes, including the manner in which it grants delegated underwriting authority and the manner in which AUS are utilized in the underwriting process.

We do note the important role played by GSE AUS systems in the market, made more so by the fact that loans meeting GSE underwriting requirements are deemed QM-compliant. We encourage FHFA to require the GSEs to provide sufficient transparency to mortgage insurers in the risk assessment of their respective AUS systems to assist MI companies in conducting their AUS evaluations, thereby assisting lenders who utilize GSE AUS in their underwriting process.

6. Are there other Approved Insurer Operational Performance Scorecard metrics that should be considered?

Response: We urge the GSEs to initiate a collaborative Operational Performance Scorecard work-stream with the MI industry to develop the metrics, thresholds and rating process to be utilized. We further recommend that metrics and thresholds be established for MI company activities related to review and approval of loss mitigation decisions and that the PMIERs withdraw the requirement that MI companies provide a full delegation of loss mitigation authority.

7. How should Operational Performance Scorecard thresholds be determined?

Response: We urge the GSEs to initiate a collaborative Operational Performance Scorecard work-stream with the MI industry to develop the metrics, thresholds and rating process to be utilized.

8. How should Approved Insurers be rated under the Operational Performance Scorecard?

Response: We urge the GSEs to initiate a collaborative Operational Performance Scorecard work-stream with the MI industry to develop the metrics, thresholds and rating process to be utilized.

9. How would Operational Performance Scorecard thresholds be applied?

Response: We urge the GSEs to initiate a collaborative Operational Performance Scorecard work-stream with the MI industry to develop the metrics, thresholds and rating process to be utilized.

B. Claims Processing and Loss Mitigation

12. Should the Enterprises impose pricing adjustments for acquired loans where an Approved Insurer does not provide a full delegation of loss mitigation? Does a lack of full delegation unnecessarily expose the Enterprises to foreseeable costs? Should there be exceptions to what constitutes full delegation of loss mitigation?

Response: MIs have a contractual right in our GSE-approved master policies to a role in loss mitigation and FHFA should not allow the PMIERs to mandate a full delegation or enforce such a mandate through GSE g-fee surcharges. Full delegation of an MI company's authority to approve short sales and deeds-in-lieu of foreclosure was requested by FHFA and the GSE as necessary response to the housing crisis and the resulting large numbers of defaulted loans. However, as the crisis is resolved we believe for well-underwritten loans and under normal economic conditions, there is a very high likelihood that the economic interests of the GSEs and of MI companies will differ because the MI bears the first loss and is more likely to incur a disproportionate share, if not the entire, loss. Full delegation from the first-loss insurer to the second loss insured suffers from an inherent potential conflict of interest as the economic interests of the parties may not be aligned, and as such may be imprudent absent other mitigating controls. In addition, the lack of involvement by MI companies deprives the system a significant intended benefit stemming from the oversight of private companies with capital at risk.

We believe that the provisions of Section 310 in the PMIERs stating the full delegations should be provided and granting the GSEs the right to differentiate g-fees depending on MI delegation should be withdrawn. Full delegation is not a fundamental question of counterparty safety and

soundness, which is the focus and intent of the PMIERs. Rather, the provision is an effort to extend into the PMIERs an important point of business and policy difference which merits an appropriate resolution. We strongly urge FHFA to remove the language in section 310 stating that MI companies should provide a full delegation and allowing for g-fee adjustments on loans insured by an MI company that does not provide a full delegation. Instead, we urge FHFA and the GSEs to engage with Essent and the MI industry on further discussions with regard to a framework for loss mitigation that strikes an appropriate balance for the system. In addition, we believe it would be appropriate in the Operational Scorecard to be developed to monitor MI performance to include metrics and thresholds with regard to efficient and responsible utilization by MI companies of their master policy rights to review and approve loss mitigation decisions. We look forward to working with FHFA and the GSEs on such a resolution that would be effective for MIs, GSEs and servicers.

C. Quality Control

15. Do the draft quality control standards present any unintended consequences?

Response: A robust, sampling based, quality assurance (“QA”) program is integral to maintain the appropriate risk focus and functioning of any mortgage credit risk entity, especially entities like mortgage insurers who essentially “buy and hold” on their books a very long-tailed asset class. A well designed QA program can improve an MI company’s risk profile in many ways, including giving comfort to senior management regarding the manufacturing quality of the business being insured, improving consistency among staff underwriters and providing an early warning of deterioration in the standards. Further, a well-designed QA program inclusive of consistent feedback and remediation can also have positive consequences on the overall risk position of the industry, including the originating lender and the GSEs. QA programs can allow an MI to detect manufacturing problems associated with individual lenders early on, and can allow for remediation of the root causes, if the associated feedback and corrective action plans are executed upon properly. By detecting and addressing root causes, the QA work on a small fraction (5-10%) of the overall loan production can lead to potential improvements on 100% of the insured population. This reduces risks both to the lender (e.g., repurchases) and the GSEs (with regard to credit risk), and improves the quality of the end investor and MI portfolios. Since a lender’s process improvements will typically extend to their entire production environment, the cumulative effects will most likely extend beyond the above 80 LTV production to below 80 LTV production as well.

While well-designed QA programs can have several benefits for the MI and the industry, there is risk that achievement of these benefits becomes the victim of well-intentioned, but unintended consequences. The greatest concern is that a QA program focused on managing risk comes into conflict with the need to enforce the MI contract, and adopts a transactional focus. This is especially true if the QA approach utilizes small but statistically valid samples (e.g., 5-10%) of production. A transactional insurability focus on the QA sample, while delivering comfort regarding insurability of a small slice of sampled production, could distract from the bigger picture goal of providing customer feedback and development of improvement plans for a lender’s origination process which would have had the potential to lead to a global improvement in manufacturing quality. The downside risks to a QA program may manifest itself if an MI of its own volition, or under instruction from a regulatory authority, adopts a transactional, insurability

determination oriented focus, to QA. We therefore recognize the risk that QA program use could be self-limited, as the PMIERs and Master Policy standards could result in the creation of incentives to scale back QA programs, so as not to invoke contract enforcement with regard to certain observed underwriting defects on otherwise performing loans. Thus, incentives could be created that could include a scaling back of a QA program – an unintended consequence of otherwise well-intentioned QA standards.

D. Financial Requirements

20. Is the segregation of books of business by vintages appropriate?

Response: Yes, the vintage groupings utilized are reasonable and should be preserved.

21. How often should the grids be updated?

Response: Infrequently. The PMIER grids are sufficiently risk sensitive, and represent a major advance over the existing frameworks for MI capital adequacy. Given the strong standards proposed in the PMIERs, the existing girds should be able to appropriately capitalize the risks for many years to come. Further given the turmoil in capital management plans, likely due to changes in the grids, we advocate no changes to the grids for several years.

23. What comments or suggestions are there related to the use of multipliers for certain loans with certain high risk features?

Response: The use of multipliers for higher risk features is a common practice. We urge that they be set at levels that reflect as closely as possible observed credit performance impacts on loans of the type expected to be insured under the PMIERs requirements. One suggestion is to clarify that the non-owner occupied multiplier applies only to investor loans and not second homes, which we understand is the intended application of the multiplier.

24. It is common underwriting practice to consider additional factors that help reduce or offset risks associated with higher DTIs (often described as compensating factors). Should the Enterprises take compensating factors into consideration when determining risk multipliers as described in Exhibit A, table 3a? How should compensating factors be incorporated into table 3a?

25. An alternative would be to have several DTI risk multipliers, for example, 43%, 45%, 47% and greater than 50%. What are the merits or drawbacks of this approach?

Responses to Questions 24 & 25: The U.S. mortgage credit risk contract is extremely complex, and is characterized by multiple factors and phenomenon that could require a very complex and multi-faceted capital framework. Such level of complexity is not warranted for a regulatory capital framework that needs to be compatible with the practical aspects of capital management. There are aspects of the PMIERs framework that could be improved to better align capital to risk – such as a more granular FICO grid. These adjustments can be implemented easily into the framework without compromising its transparency and simplicity. We recommend

against introducing significant complexity into the process by incorporating every variable or scenario that is correlated with mortgage credit risk.

Macroeconomic Scenarios

26. What comments or suggestions are there related to using the house price, interest rate and unemployment rate projections from the CCAR Baseline scenario for calculating the grids for Pre-2009 and delinquent policies?

Response: We do not see an economic rationale for treating the pre-2009 vintages to a reduced stress scenario; this also seems incongruent with the development of required assets that ensure all Approved Insurers are capable of withstanding a uniform standard of economic stress.

28. What comments or suggestions are there related to using the house price, interest rate and unemployment rate projections from the CCAR Baseline scenario for calculating the grid values for loans refinanced through HARP?

Response: The application of a standard baseline scenario is incongruent with a capital adequacy standard, whether a HARP refinance or other credit exposure. Furthermore, no valid theoretical basis is offered to support the application of internally inconsistent scenarios within the PMIERs. The resulting PMIERs asset requirement tables show asset requirements for HARP loans across most FICO/LTV cells typically 20% to 40% of equivalent non-HARP loans. Applied to a typical book of post 2008, non-HARP business, the HARP asset factors would indicate required asset levels more than 75% below those indicated by the non-HARP factors. Importantly, in contrast to their relatively favorable asset requirements, we have observed actual performance of HARP loans to be significantly inferior vs. non-HARP overall and within individual FICO/LTV cells. These findings suggest that HARP loans are in fact more susceptible to stress than non-HARP loans and should not be afforded more lenient asset requirements.

Available Assets

29. What is the appropriate frequency for an Approved Insurer's senior management team to certify compliance with the available and minimum required asset provisions of Section 704?

Response: Annually.

30. What suggested changes are there to the categories either included or excluded from the definition of Available Assets?

Response: Clarify treatment of UPR exclusion for an affiliated, exclusive reinsurer. We believe the intent of the PMIERs is to exclude UPR held by an affiliated, exclusive reinsurer but the text does not make this sufficiently clear. Disparate treatments between the flagship approved insurer and affiliated, exclusive insurers in regards to UPR could lead to regulatory arbitrage that could undermine the standards.

31. What comments or suggestions are there related to the proposed treatment of premium income in Available Assets?

Response: The inclusion of a 210% premium benefit for legacy vintages seems arbitrary and inconsistent with the treatment of 2009 and later business. Given the underlying framework of the PMIERs to establish strong standards of available assets on hand sufficient to pay claims, the policy justification for inclusion of premiums for pre-2009 vintages is unclear. In addition, we support the framework of the PMIERs as proposed for 2009 and later vintages and recommend not including premium income at this time.

33. Should premium income for the Post-2009 vintages be included in the calculation of Available Assets, and if so, should the inclusion of this premium income be limited to the transition period, or should it extend beyond the transition period? What would be an appropriate phase-out and/or haircut for premium income credit given during the transition period

Response: No. The inclusion arbitrarily reduces the rigor of the PMIER capital standard without economic justification. See *Premium Income as an Available Asset* section above in this letter.

34. Should unearned premium reserves (UPR) be included in the calculation of Available Assets? Should there be different treatment of refundable versus non-refundable premium?

Response: No. The PMIERs should maintain an economic equivalence in the calculation of required assets with respect to monthly and single premium products. Recognition of UPR would create regulatory capital arbitrage incentives to insure loans with single premium products. The PMIERs was designed to establish required assets without inclusion of future premiums and should maintain that approach. If the approach is revised, the treatment should not create regulatory incentives that are not economic.

Alternative Approaches

35. Should an alternative approach to determining Minimum Required Assets be considered in the future? If so, please describe the approach.

Response: Yes. Primary MI on less than or equal to 80% LTV loans should not be subject to the 5.6% minimum asset requirement for above 80 LTV, primary business. We recommend instead a floor of 3% to better align with the lower risk of insuring these loans. The effective floor would then be a blend of the required minimum on above 80% LTV at 5.6% and the 80% and below at 3% (such as by using a risk-in-force based weighting scheme). This calculation should be very simple to implement and monitor.

Limitations Triggered by a Minimum Required Assets Shortfall

36. What comments or suggestions are there related to the limitations triggered by an Available Assets shortfall to the Minimum Required Assets Amount described in Section 706 if they were expanded to include:

a. Paying dividends, making any payments, or pledging or transfer asset(s) to any affiliate or investor; and

b. Assuming any obligations or liabilities other than those arising from mortgage guaranty insurance policies.

Response: We believe as monoline mortgage insurers and given all the prudential limitations further imposed on MIs in the PMIERs, item (b) above is not necessary and should be removed. Item (a) above is very broad and there may still be circumstances where such payments are appropriate. We would urge that if requirement (a) is adopted, latitude be preserved to make appropriate exceptions.

Risk Sharing and Reinsurance

37. Should risk sharing or reinsurance transactions that do not receive full credit for the risk transferred under GAAP or SAP be permitted, and, if so, what limitations should there be on such transactions?

Response: In general, we believe such transaction should not be permitted but we recommend that the PMIERs provide flexibility for the GSEs to review and approve exceptions based on the merits of a given transaction.

Overall Impact

40. What may be the impact, if any, on high LTV borrowers of the draft PMIERs?

See response provided to questions 40-43 together under question 43.

41. What may be the impact, if any, on low credit score borrowers of the draft PMIERs?

See response provided to questions 40-43 together under question 43.

42. What may be the impact, if any, on Seller/Servicers of the draft PMIERs?

See response provided to questions 40-43 together under question 43.

43. What may be the impact, if any, of the draft PMIERs on Approved Insurers who are considering writing forms of insurance that are different from the traditional loan-level, borrower-paid mortgage insurance (BPMI)?

Responses to Questions 40 - 43: We do not see any material impact of the PMIERs on either the availability of credit or MI pricing based on the current mix of business being insured in the market. The industry has recovered nicely buoyed by a recovering economy, and the MIs have managed to access the capital markets to raise capital depleted during the down turn. Industry pricing has steadily decreased over the last several years, which in turn has improved credit access for the first time and other low down payment borrower segments. One positive impact of the PMIERs on high LTV borrowers may be that the GSEs view the MIs that are able to comply

with the PMIER requirements in a positive light, and the confidence engendered by this compliance allows them to reduce apparent haircuts on MI payments that currently underlie the GSE g-fee pricing. Thus, in this manner, the finalization of strong PMIERs has the potential to result in lower total mortgage credit costs to high LTV borrowers.

In terms of low credit score borrowers, the market is not generating a significant quantity of loans in the less than 680 FICO score segment. The industry pricing in the lower FICO segment is quite mixed; all MIs have a significant pricing differential for their credit union business for lower FICOs, a pricing paradigm that pre-dates the PMIERs by several years. Given the lack of low FICO production and the likelihood that credit union low FICO production reflected fundamental risk differences, if the production in the lower FICO tails increases, there could a rationalization of pricing in the lower FICOs. However it would be fallacy to attribute such a move to the PMIERs, but rather it would reflect the reality that inherent economic risk of the profile has shifted.

The PMIERs are robust, and should provide comfort to policy holders as well as seller/servicers who may hold assets on their own balance or may be exposed to rescission risk on loans the service about the counterparty strength of their MI partners that comply with these standards. As a consequence, the lending industry may feel more confident in providing credit access to low down payment, especially if the insurance provider is an MI that complies with the rigorous standards.

One area where very modest refinement to the PMIERs would be appropriate and could help MIs serve a broader market is to apply a 3% required asset floor to insured loans with LTVs of 80% or less. There is market interest in exploring risk sharing with MIs on this segment, and we believe a more appropriate required asset floor (versus the 5.6% currently in the PMIERs which would be appropriate the higher risk above 80% LTV segment) would better align assets to risk and remove an artificial impediment from MI service to the market.

E. Failure to Meet Requirements (Post-Transition Process)

47. Should the PMIERs include an appeals process to provide an Approved Insurer with a means to dispute remediation actions taken by the Enterprises? If so, what should that process consist of and should it apply to all remediation actions or to a subset?

Response: We feel that the GSEs have extraordinary powers to utilize their discretion to amend the PMIERs and their implementation with regard to one or another Approved Insurer. Insofar as that broad discretion is maintained, Essent believes an established appeals procedure must be ensured to balance the interests of the GSEs as a counterparty with the Approved Insurer and its interest in participating in the marketplace. At a minimum, such an appeal should include a review of proposed actions by FHFA.

F. Transition Process

50. Should the duration of a transition period for full compliance with the Financial Requirements of the revised PMIERs be consistent for all Approved Insurers or varied depending on each company's unique circumstances?

Response: We see no rationale for inconsistent application of the requirements.

Appendix C – Essent's Letter in Response to FHFA's Request for Input on GSE G-fees

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