Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

December 21, 2010

Alfred M. Pollard, Esq.
General Counsel
Attention: Comments/RIN 2590-AA36
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Dear Mr. Pollard:

The Mortgage Insurance Companies of America ("MICA") is pleased to comment on the notice of proposed rulemaking ("NPR") issued by the Federal Housing Finance Agency ("FHFA") on the joint and several liability of the Federal Home Loan Banks.[1] Although this issue is an important one to ensure a sound Home Loan Bank System, MICA shall comment specifically on the use of credit rating agency (CRA) determinations in FHFA rulemakings, as invited by this NPR. The proposal makes clear that this is just the beginning of FHFA action to comply with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] ("Dodd-Frank Act"), which requires federal agencies to delete CRA references in favor of other measures of credit-worthiness. We shall thus suggest initial matters in this area for FHFA consideration. MICA would be pleased to provide additional analytics or other information to support FHFA work to comply with this aspect of the new law, which we think an important contribution to ensuring that regulations promote use of prudent, proven credit risk mitigation demonstrated by robust internal models and supervisory validation.

MICA is the trade association representing the U.S. private mortgage insurance ("MI") industry. As such, we have a strong interest

[1] *Federal Home Loan Bank Liabilities*, 75 Fed. Reg. 68,534 (Nov. 8, 2010).

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

1425 K Street, NW
Suite 210
Washington, DC 20005
(202) 682-2683
Fax (202) 842-9252

in the role of ratings in U.S. residential finance, and we have long urged considerable caution in this regard.[3]

Indeed, we warned FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight, about this risk in our comments on the risk-based capital rules governing Fannie Mae and Freddie Mac.[4] In 2000, we warned the agency that:

> Residential mortgage credit risk is a unique type of risk. There is only one type of company whose rating is based solely on its ability to manage and absorb mortgage credit losses in a stress scenario — a private mortgage insurer. By comparison, a nonmortgage insurance company having the same rating, but without any mortgage credit expertise cannot be counted on to underwrite, manage and ultimately absorb the same level of *mortgage* credit risk as the mortgage insurance company because its rating and core business competencies most likely had little to do with its ability to absorb mortgage credit risk (and certainly not in a stress scenario). In addition, mortgage credit enhancement providers who have debt-issue-specific credit ratings (e.g., bond rating or commercial paper rating), and do *not* have a general "issuer credit rating" should be considered an unrated counterparty for the purpose of credit enhancement counterparty risk haircuts. This is because debt-issue-specific ratings, by definition, do not extend to any other business of the

---

[3] See, MICA, comment on *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 74 Fed. Reg. 52,374 (Oct. 9, 2009) *available at* http://www.sec.gov/comments/s7-17-08/s71708-24.pdf; and comment on *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 73 Fed. Reg. 40,088 (July 11, 2008) *available at* http://www.sec.gov/comments/s7-17-08/s71708-8.pdf; comment on *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, 75 Fed. Reg. 52,283 (Aug. 25, 2010) *available at* http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b76f46; comment on *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 75 Fed. Reg. 49,423, (Aug. 13, 2010) *available at* http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b6fede.

[4] MICA, comment on *Second Notice of Proposed Rulemaking (NPR2) on Risk-Based Capital Regulation,* 64 Fed. Reg. 18084 (Apr. 13, 1999) *available at* http://www.fhfa.gov/webfiles/1996/29RBC_NPR2_MICA.pdf.

rated entity and should not be substituted in the absence of a general issuer credit rating.[5]

These and other concerns noted at the time about CRAs were proven correct in the current financial crisis. Our principal recommendations to FHFA with regard to use of credit ratings for all of the government-sponsored enterprises ("GSEs") are:

- MICA understands and respects the complexity of finding alternatives to CRA determinations. However, in its CRA-related rulemakings, FHFA should reflect the complexity of credit-risk judgments and avoid over-simple solutions (e.g., deferral to CRA use by the GSEs despite deletion of ratings from applicable FHFA rules). Experience has demonstrated the ability of the GSEs to arbitrage over-simple requirements such as the ratings-drivers in the current FHFA capital rules for Fannie Mae, Freddie Mac[6] and the Federal Home Loan Banks[7]. The severe losses each of these GSEs is now suffering related to holdings of mortgage-backed securities ("MBS") initially granted AAAs or equivalent ratings is clear evidence of the risk of CRA reliance in capital regulations. FHFA rules deleting CRA references should look to the nature of collateral and guarantees, reflecting risk judgments without regard to structuring or other, uncapitalized forms of credit risk mitigation.

- Judgments about the credit risk of mortgages, MBS and other mortgage-related obligations should in part be based on the existence of proven, capitalized forms of credit enhancement such as MI. MICA below provides a detailed update on the condition of the U.S. MI industry to demonstrate that – unique among private sources of capital for U.S. residential mortgage finance – MI is not only honoring its claims, but also has excess capital capacity to promote market recovery. Recognition of robust forms of credit-risk mitigation (CRM) like private mortgage insurance will provide meaningful protection to the GSEs and to financial markets, since CRM not only provides an initial layer of risk mitigation, but also "double-default" risk-reduction benefits.

- Congress has established precedent for recognizing MI and other key credit-risk judgments in Section 941 of the Dodd-Frank Act.

---

[5] *Id.* at 28.

[6] 12 C.F.R. § 1750 (2010).

[7] 12 C.F.R. § 932 (2010).

These criteria apply to all asset-backed securities ("ABS") as well as to MBS. MICA urges the FHFA to work with other agencies to craft a final rule implementing this section of the law to provide criteria for prudent MBS that may then be reflected in FHFA's broader regulations. The criterion dictated by Congress in Section 941 – demonstrated and historical record of reduced risk of default – governs qualified residential mortgages, with Congress rightly including use of private MI as a criterion for this determination. Comparable standards should also govern other FHFA rulemakings and recognize MI as a criterion that satisfies stringent credit-worthiness requirements.

Finally, we attached to this comment an appendix providing data on the performance of the private MI industry in the recent crisis. It demonstrates the ability of MI not only to reduce default on mortgages, but also to promote "cures" that prevent ultimate default. These data strongly support recognition of MI in future regulatory judgments about mortgage-related credit risk.

I. CRA Judgments Should be Replaced with Care and Prevent Reliance on Subjective, Unproven Credit-Risk Criteria

While MICA strongly endorses stringent CRA reform and the least possible use of ratings in federal regulation, we recognize that changing current rules is problematic if the replacement is simple reliance on GSE internal credit-risk judgment. Daniel Tarullo, Governor of the Federal Reserve Board ("FRB"), has noted that:

> [T]he substantial effort expended by staff at the Board and the Federal Reserve Bank of New York to evaluate the creditworthiness of a relatively small number of securitizations in the Term Asset-Backed Securities Loan Facility suggests the enormity of that task [replacing ratings].[8]

These comments reinforce not only the complexity of the task that faces the agencies in the wake of Section 939A, but also the hazard of simple deletion of CRA references without appropriate replacements that meet the goal of credit-risk criteria that are, as stated in a recent proposal from the Office of the Comptroller of the Currency,

[8] Daniel Tarullo, *speech before the Brookings Panel on Economic Activity* (September 17, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20100917a.htm.

"transparent, replicable, and well defined."[9] MICA thus opposes options such as use of a simple risk weighting based on factors such as asset class. This would, we believe, put the U.S. back to the 1988 Basel I Accord – if not even the less risk-based capital rules that preceded it – invalidating all of the work under way since the crisis to craft the global standards known as Basel III.[10] Congress made clear in the Housing and Economic Recovery Act of 2008[11] that it seeks a similar, sophisticated risk-based and minimum capital regime for the GSEs, eliminating prior statutory restrictions and expressly authorizing FHFA to enhance GSE regulatory capital to reflect real risk.

MICA recommends that the FHFA act on an option detailed in an inter-agency capital advance notice of proposed rulemaking ("ANPR") issued by the federal banking agencies to implement Section 939A.[12] The ANPR suggests that creditworthiness be assessed based on the guarantee or collateral backing mortgages. We shall discuss this option in more detail below.

However, as FHFA implements this directive, MICA urges it not to allow the GSEs to establish capital risk weights for residential mortgages through simple reliance on consumer credit scores. The data presented below highlight the complexities in accurately gauging mortgage credit risk, emphasizing the importance of combined loan-to-value (LTV) ratios at origination, full documentation, and the presence of MI, among other factors.

II. Recognition of Proven Guarantees Will Promote Sound Mortgage Finance and Market Recovery

MICA believes that the general approach outlined above to replacing express reliance on CRAs can be applied to residential mortgages and MBS by reference to proven forms of capitalized credit risk mitigation. Where it exists, creditworthiness is dramatically enhanced as long as the CRM provides a deep layer of first-loss

---

[9] *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 75 Fed. Reg. 49,423 at 49,426 (Aug. 13, 2010).

[10] Bank for International Settlements, *Results of the December 2010 Meeting of the Basel Committee on Banking Supervision* (Dec. 1, 2010) *available at* http://www.bis.org/press/p101201a.htm.

[11] Pub. L. No. 110-289, §1110 (July 30, 2008).

[12] *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, 75 Fed. Reg. 52,283 (August 25, 2010).

protection and has demonstrated capacity to absorb risk under high-stress scenarios.

Indeed, reliance on guarantors provides "double-default" protection, rightly (if incompletely) recognized in the banking agencies' rules to implement the advanced approaches under the Basel II Accord.[13] Double-default protection means that a bank is at credit risk only upon default of an obligation and, even then, only if the CRM provider fails to honor its obligations. Failure to recognize this benefit in creditworthiness judgments made by the FHFA in the absence of credit ratings will expose the GSEs to undue and unnecessary risk. It is also a straightforward way to judge credit risk – if a GSE has CRM in place of an investment asset like an MBS does and if the CRM meets regulatory specifications, then credit risk is meaningfully reduced in ways that can and should be recognized by the FHFA.

The Joint Forum of global banking, securities and insurance regulators has assessed various forms of credit risk transfer (CRT).[14] This work has pioneered reform of credit derivatives, although much work there still is required to achieve the Joint Forum goal of ensuring capitalized, regulated CRT. However, recognition now of MI and other forms of comparable credit guarantees in FHFA regulations to replace CRA reliance will ensure true risk reduction without leading to undue reliance by the GSEs on untested CRT structures or providers.

The performance of private mortgage insurance in the current crisis makes clear how robust this risk-mitigation function has proved and how large a role private forms of credit risk mitigation can play to stabilize key market sectors. MICA members currently have insurance in force of $766 billion, backing residential mortgages with LTV ratios above eighty percent. At the end of the second quarter of this year, 7.5 percent of the U.S. residential mortgage sector was protected with private MI.

As the FHFA knows well, the most critical criterion for credit-risk mitigation is capital, and private MI in the United States is characterized by unique and counter-cyclical capital requirements. Fifty cents of every premium dollar must be placed in a contingent reserve, and generally held for ten years, a capital structure designed to ensure the ability of MI firms to bear even catastrophic risk during

---

[13] See the applicable treatment in the OCC's regulations, 12 CFR part 3, Appendix C, Section 2.

[14] See Joint Forum, *Credit Risk Transfer - Developments from 2005 to 2007* (July 2008), *available at* http://www.bis.org/publ/joint21.pdf; and Joint Forum, *Credit Risk Transfer* (March 18, 2005), *available at* http://www.bis.org/publ/joint13.pdf.

severe market downturns. On page 1 of the attached appendix, the historical performance of the MI countercyclical capital model is set forth showing how capital resources are built up during good economic times to pay claims during economic downturns. As noted, the MI capital model is currently working exactly as it was designed to work—paying claims using a decade's worth of premiums.

The current U.S. mortgage market is, of course, in the midst of a downturn of unprecedented severity. MICA began to warn regulators of emerging high-risk trends in U.S. mortgage-underwriting practice as early as 2002, although it was not until 2006 that regulators addressed these issues,[15] and implementation and meaningful enforcement was lacking even then. This led to contagion risk, with the problems MICA identified in the non-traditional sector migrating to the conventional, conforming market, contributing to systemic risk and the conservatorship of Fannie Mae and Freddie Mac.

Despite this, U.S. private mortgage insurers have not only honored their claims, but have also attracted new capital – a tribute to the faith investors have in a sector designed to take risk related to high-LTV mortgages. Since the onset of the crisis, MIs have raised $7.4 billion in new capital, with a new entrant to the industry supplementing MI capacity by an additional $575 million in new capital. MIs have also paid $20.8 billion in claims and receivables to Fannie Mae and Freddie Mac, equivalent to over 13 percent of taxpayer investments in the GSEs since the beginning of their conservatorships. In addition, MIs spent considerable dollars helping with loan modifications to keep borrowers in their homes, leading to a much better cure rate for loans insured by MIs. This was all accomplished without any financial assistance from the government.

However, the MI contribution to credit-risk mitigation is not limited to its unique capital structure. MIs also provide a second set of eyes to review origination practices. Furthermore, an MI's capital at risk ensures incentive alignment with that of borrowers and investors. In sharp contrast to credit derivatives and financial guarantee insurance (extensively assessed in the Joint Forum papers referenced above), U.S. mortgage insurers are not permitted by state regulation to invest in correlated assets, thus ensuring their capacity to provide not only CRM, but also double-default benefit.

---

[15] *Interagency Guidance on Nontraditional Mortgage Product Risks* (Sept. 29, 2006), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20060929a1.pdf
.

The performance of insured mortgages during the current period of economic and mortgage market stress reflects these important attributes. In the attached appendix, we have provided data on the recent mortgage-market crisis and the performance of insured low down payment mortgages versus uninsured comparable mortgages. The details of the study are set forth on page 2 of the appendix. A database of 120 million loans was utilized to determine the performance of qualified mortgages versus non-qualified mortgages during the current period of mortgage market stress.

The chart on page 2 of the appendix shows that qualified mortgages—those with full documentation, fixed loan terms and mortgage insurance (if the loan had an LTV above 80%)—performed significantly better than non-qualified loans that were originated during the same years. The study also analyzed 3.8 million residential mortgage loans that were insured and 1.1 million comparable high-LTV loans that were uninsured (these loans were piggyback mortgages).

The chart on page 4 shows that the insured loans resulted in 47 percent fewer delinquencies than the uninsured loans. The chart on page 5 shows that insured loans had a 54 percent higher cure rate than uninsured loans. Cured loans are modified or otherwise corrected so that the borrower does not go into default. This in turn ensures lower foreclosures, protecting banks, borrowers and the financial system more generally.

The chart on page 6 shows that, when looking at the nonperforming rates of the loan by each origination year, the ratio of nonperforming piggybacks to nonperforming insured loans averaged 65% higher. This clearly indicates that insured low down payment loans have a lower risk of default than comparable uninsured loans. Additionally, the chart on page 7 shows that qualified insured mortgages performed better than insured mortgages overall and that uninsured high LTV mortgages performed significantly worse than either of the other loan groups.

In short, even during the current serious stress period qualified insured loans have performed well.

III. Dodd-Frank Provides Precedent for MI Recognition

As noted, Title IX of the Dodd-Frank Act not only requires deletion of CRA references, but also establishes a new framework for the regulation of asset securitization. While seemingly separate, the goals of Section 941 – dealing with ABS – and 939A are consistent: to

reduce credit risk in the financial system to protect borrowers, banks and the financial system. Thus, MICA urges the FHFA to consider the criteria established in Section 941 that identify "qualified residential mortgages" exempt from mandatory risk retention also as criteria for the highest regulatory standard of credit-worthiness applicable to the GSEs for regulatory-capital and all other applicable purposes.

Section 941 stipulates that the FHFA and other cited agencies should consider
"underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as:

- documentation and verification of the financial resources relied upon to qualify the mortgagor;
- standards with respect to—
    - the residual income of the mortgagor after all monthly obligations;
    - the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;
    - the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;
    - mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;
    - mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and
    - prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default."

To support Congress' directive that regulators address the historical risk of default, MICA members have developed extensive data. As noted, this is provided in the appendix to this comment letter. It is based on third-party data the FHFA may obtain if desired and run on its own to validate the conclusions. The data not only support the foreclosure-prevention conclusions noted above, but also the historical performance of private MI before and throughout the current crisis. Our members would be pleased to meet with FHFA to further explain the analysis.

Conclusion

MICA respectfully urges the FHFA to avoid over-simple alternatives to rating-agency designations and, at the same time, not to defer solely to GSE representations of credit risk, as these must be validated by objective criteria such as the presence of proven, capitalized forms of credit risk mitigation like mortgage insurance. We will be pleased to provide additional information on the data presented to support these points and to support FHFA analytics in any other way of use as the agency pursues Congress' directive in this area.

Sincerely,

Suzanne C. Hutchinson