Mortgage Insurance Companies of America

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Attention: Comments/Securitization Study

Dear Sirs:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the Federal Housing Finance Agency (FHFA) concept release on whether and how Federal Home Loan Banks (FHLBs or Banks) should be allowed to securitize mortgages. In general, MICA believes that the more entities that securitize mortgages, the more liquid the resulting secondary market and, thus, the more competitive and affordable the U.S. mortgage finance system. However, as the debacle in private-label mortgage-backed securities (MBS) makes painfully clear, it is vital that securitizers pay careful heed to the credit risk and borrower protection characteristics of the mortgages they purchase for securitization. FHLBs have already encountered significant problems with the limited mortgage-purchase plans authorized for them, which argues for considerable caution if the FHLBs are allowed, as we believe they should be, to securitize residential mortgages. FHLB mortgage securitization should be part of the solution to the current crisis, not lay the seeds for the next one.

With this general principle in mind, MICA believes that current law permits the Banks in fact to securitize mortgages, but we concur with the FHFA's caution about the degree to which current law covers not only securitization, but also Bank guarantees for the resulting MBS. To get a Bank securitization program up and running as quickly as possible and, at the same time, to limit legal and credit risk, MICA recommends that the FHFA permit Banks to securitize loans purchased from member financial institutions and then to securitize them only with credit enhancement provided from qualified private entities. We also recommend that the loans included in securitizations be subject to

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specific underwriting and related requirements. The first section below discusses options for qualified third party credit entities that could guarantee the MBS. The second section discusses origination standards that should be used on the underlying mortgages.

Qualified Third-Party Credit Enhancement for MBS

As noted, the FHFA concept release seeks comment on the degree to which the Banks may securitize mortgages under current law, concluding that this is particularly problematic if the Banks guarantee the MBS they issue. Of course, unguaranteed MBS will have very limited market appeal, perhaps mooting any Bank MBS program in which the FHLBs issue loans without also providing or obtaining a guarantee for them.

Indeed, the absence of a guarantee poses risks not only for any securitization program, but also for the Banks. Without an explicit guarantee, investors might well assume that FHLB MBS carry an implicit guarantee from the federal government because of the Banks' status as government sponsored enterprises (GSEs). This could lead to a repeat of the costly history with Fannie Mae and Freddie Mac, in which ratings agencies granted AAAs without real analytical review of true risk and investors trusted fully in ratings backed by an implicit guarantee. This of course led to significant systemic risk and billions in taxpayer costs. MICA believes, therefore, that it is vital that any FHLB securitization program be structured at the outset to ensure that no expectation of any form of implicit guarantee is permitted for the securitization structure.

To ensure a successful FHLB securitization program that does not lead to legal challenges and investor implicit-guarantee expectations, MICA recommends that the FHFA permit FHLB securitization structures only if valid forms of third-party credit enhancement are provided. Options that have been used or discussed in the markets are credit derivative, covered bonds and private mortgage insurance.

> <u>Credit derivatives</u> - Credit-derivatives were widely used in the recent market. As the FHFA knows, however, this market was permitted to grow to such an extent as to cause a huge systemic risk problem. This was due in large part to significant regulatory lapses that permitted counterparties to take on billions in credit-derivative risk without adequate capital to meet claims. Further, significant operational problems in the credit-derivatives market – now being slowly remedied by global regulators – meant that credit-derivative buyers often did not even know who their

ultimate obligor was, let alone if the counterparty in fact could honor its obligation.

In light of the market debacle, the G-20 summit has identified credit derivatives as a critical issue and global regulators are now working to repair this market through an array of new rules, including capital requirements. However, this effort has only just begun. Further, even after the new regulatory regime is instituted, it will remain unclear if it is sufficiently robust to absorb another round of market stress. As a result, MICA urges the FHFA to adopt a highly-cautious approach to credit derivatives.

Covered bonds - The FHFA also could consider securitization through the covered bond structure recently developed by the FDIC and Treasury for U.S. insured depositories.[1] Covered bonds ensure investor protection because of full collateralization, although it is of course vital to ensure that the loans backing covered bonds are of sufficient quality to provide meaningful collateral. MICA supported the expanded use of covered bonds and still does provided the underlying mortgages are safely and soundly underwritten. In the next section, MICA suggests underwriting criteria that would achieve this goal.

Regulated, capitalized firms such as private mortgage insurers[2]- MICA also recommends that FHFA allow regulated, capitalized firms such as private mortgage insurers to provide credit enhancement for FHLB securitizations. Private mortgage insurance is monoline. All its capital and reserves must go to paying claims on mortgages. MIs' regulatory capital is structured in the counter-cyclical way bank regulators are now seeking to emulate for insured depositories. MIs are required in all states to establish "contingency reserves" – that is, half of every dollar of new premium income is placed in a reserve fund for ten years to ensure adequate capitalization under stress scenarios. This structure builds capital during benign market conditions to ensure MIs can handle claims under even catastrophic risk conditions. No other form of regulated credit enhancement has yet adopted this counter-cyclical capital

[1] FDIC Covered Bond Policy Statement, Final Statement of Policy, 73 FR 43754. United States Department of the Treasury, Best Practices for Residential Covered Bonds, July 2008.

[2] FHFA solicited comments on whether a private mortgage insurer should be allowed to insure collateralized debt obligation (CDO) tranches resulting from FHLB securitizations. MICA supports this approach in light of the reliable, capitalized credit enhancement provided by private mortgage insurers.

structure, often called "dynamic provisioning" by bank regulators, although the global Financial Stability Board and other top level regulatory bodies are now moving to implement it for banks and other financial institutions.

MICA also urges that the FHFA adopt other standards for the guarantee. First, to avoid regulatory arbitrage and other risks, any guarantee of an MBS should be for the entire amount of the MBS, regardless of whether the securitization is subsequently tranched or otherwise structured. Without a full and simple guarantee, the Banks could be liable for high-risk mortgage tranches in which investors again rely on the implicit guarantee or other undue protections.

In authorizing credit enhancement by regulated, capitalized firms, FHFA also should ensure that there are no conflicts of interest that threaten both the integrity of the securitization and the guarantee. Thus, it should not allow a member both to originate mortgages for an FHLB securitization and guarantee the resulting MBS. Permitting this would not only expose the Banks and investors to conflicts of interest that undermine the value of a third-party guarantee, but also create an opportunity for member banks and savings associations to use the System for regulatory-capital arbitrage. As you know, the regulatory capital required by the banking agencies under both the Basel I and II standards is far more onerous for on-balance sheet obligations than for off-balance sheet guarantees. Since the risk to an originating bank in fact would be the same if it simply transformed a mortgage into a mortgage guarantee, this should be disallowed.

Origination Standards

As FHFA is all too well aware, recent mortgage origination standards have been woefully inadequate. This is, of course, now being remedied through rules such as the 2008 Federal Reserve standards pursuant to the Homeownership and Equity Protection Act (HOEPA).[3] However, many problematic mortgage structures and underwriting practices remain, exposing the FHLBs and mortgage borrowers to significant risk unless the FHFA ensures appropriate underwriting standards as a condition for Bank securitization. Listed below are the standards MICA suggests.

<u>Loan level credit enhancement</u> - Loan-level credit enhancement for any loans with initial loan-to-value (LTV) ratios above eighty percent should be required. This, of course, is required for Fannie Mae and Freddie Mac[4] and should be similarly

[3] 73 FR 44521.
[4] 12 USC 1717 and 12 USC 1454 respectively.

mandated for the Banks. Third-party credit enhancement through qualified insurance, recourse and participations – as provided in the other GSE charters – ensures not only credit-risk mitigation, but also third-party, objective underwriting in which incentives are directly aligned with those of the borrower and investor.

Piggyback loans –To ensure that current market problems are not repeated, the FHFA should not only mandate credit enhancement for high-LTV loans, but also bar any securitization of loans where a first and second mortgage are originated simultaneously such that the combined loan-to-value is above 80% (i.e., "piggyback mortgages").

Prohibit no-doc loans - A prohibition on no-documentation loans, with all originators required not only to obtain income and related documentation, but also to verify it, should be required.

Underwriting based on ability-to-repay - Underwriting based on ability-to-repay should be required. The criteria should reflect the full cost of the mortgage (including taxes and insurance) as well as interest rate costs based on full amortization for adjustable rate mortgages (ARMs) and principal increases in negative-amortization loans.

Regulated entities – Loans should be originated only through entities in full compliance with applicable state and federal registration standards.

Conclusion

MICA supports FHLB mortgage-securitization activities, but only in connection with restrictions to ensure the resulting MBS pose no threat to the Banks, borrowers or broader financial markets. To protect these critical interests, FHLB MBS should carry guarantees from regulated, capitalized and proven providers of credit risk mitigation, with FHFA urged also to explore covered-bond securitization structures for the Banks. MICA also urges that mortgages sold through FHLB securitizations be subject to strict underwriting criteria that include reliance on third-party credit enhancement for high-LTV loans and numerous borrower protections. We would be pleased to provide additional information and otherwise support the FHFA as it considers this important issue.

Sincerely,

Suzanne Hutchinson

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