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Housing Finance & Regulatory Affairs

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Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, DC 20024
Attn: Mortgage Insurance Eligibility Project

Re: Request for Public Input
Private Mortgage Insurer Eligibility Requirements

Submitted via Electronic Delivery: www.fhfa.gov/open-for-comment-or-input

Dear Sir or Madam:

On behalf of the National Association of Home Builders (NAHB), I appreciate the opportunity to respond to the Federal Housing Finance Agency's (FHFA) Request for Public Input (RFI) on the draft revised Private Mortgage Insurer Eligibility Requirements (PMIERs) for mortgage insurers seeking approval to insure loans owned or guaranteed by Fannie Mae and Freddie Mac (the "Enterprises"). Private mortgage insurance (PMI) remains the primary form of credit enhancement on mortgage loans purchased by the Enterprises. This high level of dependency on PMI makes it critical for the Enterprises to have confidence that the financial strength and business requirements of these important counterparties will provide sufficient protection to the Enterprises in all economic scenarios and particularly in times of severe economic stress.

NAHB is a Washington-based trade association representing more than 140,000 members involved in all aspects of single-family and multifamily residential construction. The ability of the home building industry to meet the demand for housing, including addressing affordable housing needs, and contribute significantly to the nation's economic growth is dependent on an efficiently operating housing finance system that offers home buyers access to affordable mortgage financing at reasonable interest rates through all business conditions.

Background

The current model of private mortgage insurance has been providing lenders and investors protection from credit losses due to borrower defaults and foreclosure on low downpayment mortgage loans since the 1950s. Before private mortgage insurance, the federal government was supporting homeownership solely through the Federal Housing Administration's (FHA) insurance program that encouraged mortgage lending by guaranteeing lenders full repayment of a mortgage in the event of foreclosure. In the 1950s, as house prices were increasing and home buyers wanted to purchase larger homes, more borrowers required mortgage loans above the FHA's loan limits. However, conventional mortgage loans at this time generally required a 20 percent downpayment – a considerable barrier for many moderate-income home buyers.

Fannie Mae, chartered in 1938, was allowed to purchase conventional mortgage loans above 80 percent loan-to-value but its charter required a third-party credit enhancement to take a first-loss position. As more borrowers sought a low downpayment option, market influences created demand for an alternative source of mortgage insurance and PMI became the most commonly used credit enhancement on loans purchased by Fannie Mae and later by Freddie Mac – whose 1970 charter also required third-party credit enhancement on all loans purchased with a loan-to-value above 80 percent.

PMI has made a significant contribution to the housing market and homeownership by supporting low downpayment mortgage loans with a relatively affordable credit enhancement. PMI protects lenders and investors from credit risk, but it is paid for by borrowers and monthly premium payments are included in a borrower's monthly mortgage payment. Mortgage loans that lenders would have considered risky to hold in portfolio, and the Enterprises would have been unable to purchase, were originated because PMI was available and affordable.

As the conventional mortgage industry grew, the PMI industry grew with it. In 2000, almost 60 percent of originated insured mortgages carried PMI and this number reached 77 percent in 2007. During the housing market downturn, this share fell off dramatically when PMI premiums increased and the PMI share fell as low as 15 percent in 2009. In the first quarter of 2014, the percent of the mortgage market that is insured was 36.2 percent and 41.4 percent of the insured market carried PMI.

Private mortgage insurers are regulated by state insurance regulators which have the same objectives that FHFA intends to achieve with PMIERs. State regulators and FHFA want to ensure mortgage insurance companies are positioned financially to remain solvent and pay claims over the long term and through periods of economic stress. Indeed, mortgage insurers themselves have a significant interest in maintaining a financial profile that will ensure their ability to meet their claims-paying obligations and remain solvent through all economic scenarios. As mortgage insurers bear the first-loss position on the loans they insure, they also have a vested interest in effective risk-management strategies to mitigate credit losses and foreclosure.

State insurance regulators impose Reserve Requirements, Capital Requirements, Investment Restrictions, Concentration Restrictions and Monoline Restrictions on mortgage insurers domiciled or doing business in their state. Reserve requirements are especially stringent and consist of three categories: 1) Contingency Reserves to provide for major losses in a severe and unexpected loss scenario. Fifty percent of all net earned premiums are set aside in a contingency reserve fund and cannot be released for 10 years unless the insurer experiences high losses and receives approval from the state insurance regulator to draw down the reserves to pay claims; 2) Loss Reserves to cover expected losses on delinquent loans; and 3) Unearned Premium Reserves which are reserves consisting of any premiums paid before the insurance coverage period begins.

Mortgage insurance companies also are limited by state regulators on the ways in which they invest their reserves and in their exposure within certain census tracks. As monoline insurance companies, they generally cannot engage in activities other than mortgage-related insurance.

The regulations imposed on mortgage insurers by the state regulators will not be affected by the implementation of PMIERs.

Not only are mortgage insurers regulated by state regulators, they also are subject to stringent review by credit rating agencies. Historically, the Enterprises have relied to a large degree on the due diligence of state regulators and credit rating agencies to ensure the financial soundness of mortgage insurers rather than performing their own review. Since the mortgage market crisis, the Enterprises have begun to do more of their own evaluation of mortgage insurers - reviewing the financial picture of each mortgage insurer in the context of its unique situation. The updated PMIERs are intended to bring consistency and enhanced diligence to the assessment of a mortgage insurer's qualifications as a safe and sound counterparty to the Enterprises.

Though the mortgage industry experienced unprecedented losses during the Great Recession, it is worth noting that according to information from the U.S. Mortgage Insurers, the industry has paid approximately $42 billion in claims to Fannie Mae and Freddie Mac since the downturn. If the industry had been unable to pay these claims, taxpayers would have suffered this extraordinary loss. Of mortgage insurance claims made by the Enterprises since the crisis, 93 percent have been paid. Of the seven mortgage insurers in business prior to the Great Recession, only one mortgage insurer benefited from federal funds received by its parent. Three were forced into runoff, i.e. no longer writing new mortgage insurance policies. Significantly, even the mortgage insurance companies that went into runoff, continued to pay claims because insurance premiums on risk-in-force continued to be collected even though no new mortgage insurance was being written. One of these now has paid 100 percent of claims; the other two currently are chipping away at claims and paying 67 cents and 75 cents on the dollar with the remainder deferred, but still expected to be paid in full. Two new, well-capitalized mortgage insurance companies have been established since the Great Recession. In essence, the mortgage insurance industry performed much as intended and has proven resilient.

Draft Private Mortgage Insurer Eligibility Requirements

The draft PMIERs would introduce a risk-based approach to setting the capital standards for mortgage insurance companies that seek to do business with Fannie Mae and Freddie Mac. A mortgage insurer would be required to have a minimum of available assets or liquid assets to pay claims. As proposed, existing mortgage insurers must have minimum available assets of the greater of $400 million or the total of risk-based required assets calculated per the risk-based asset factor grids established by FHFA. Future start-up mortgage insurers would need to have $500 million in capital. For existing mortgage insurers with a portfolio of risk-in-force, the risk-based available assets calculation will demand significantly more capital to be retained than the minimum required available assets of $400 million.

Regardless of the calculated required risk-based available asset amount, a private mortgage insurer must have a minimum risk-based asset amount of 5.6 percent of the dollar amount of risk-in-force. This is approximately equivalent to a risk-to-capital ratio of 17.8:1 (1 divided by 5.6 percent). Current capital requirements of the state regulators generally mandate that private mortgage insurers maintain a minimum risk-to-capital ratio of 25:1 although the effective risk-to-capital ratio is often lower when the contingency reserve requirement is factored into the ratio. A lower risk-to-capital ratio equates to a higher capital requirement.

FHFA has proposed a series of grids containing numeric factors to calculate the minimum required risk-based available assets. The primary risk characteristics that determine required available assets are credit score, loan-to-value, and origination year. Additional risk characteristics such as full documentation versus low-documentation; owner occupied versus non owner occupied; debt-to-income ratio higher than 43 percent versus debt-to-income ratio lower than 43 percent; and fully amortizing mortgage payments versus non-fully amortizing mortgage payments also are assigned a risk factor that must be included in the calculation for loans originated after 2008. HARP mortgage loans and non-HARP mortgage loans also have assigned risk classifications.

Each grid in the series of grids established by FHFA to calculate a mortgage insurance company's required risk-based available assets assigns a risk factor based on the loan-to-value and credit score of the individual mortgage loan insured. The tables are unique for 1) Mortgage loans originated pre-2005; 2005-2008; and post 2008; 2) Performing HARP mortgages originated pre-2005; and 2005-2008; and 3) Non-performing mortgage loans. For loans originated post 2008, an additional risk multiplier is applied for loans not underwritten with full documentation; not owner occupied; underwritten with a debt-to-income ratio greater than 43 percent; and with mortgage payments not fully amortizing.

NAHB Comments

NAHB believes the value of PMI to the housing market is unquestionable. While we acknowledge that significant vulnerabilities in the mortgage insurance industry were exposed during the recent housing market crisis, we believe appropriate steps to bolster the financial condition and risk-management of the mortgage insurance industry is more desirable than diminishing the industry's role in the future housing finance system as some housing finance system reform proposals have recommended.

NAHB believes, too, the risk-based approach to setting capital requirements for the mortgage insurance industry, as outlined in PMIERs, is a prudent enhancement to how the Enterprises currently assess the financial wherewithal of these fiscal counterparties.

FHFA's draft PMIERs address business, underwriting, quality control, and financial requirements for private mortgage insurers doing business with the Enterprises. NAHB's concerns and recommendations are focused on the financial requirements proposed by FHFA that we believe would cause mortgage insurers to increase mortgage insurance premiums unnecessarily and thereby affect affordability and availability of mortgage loans with loan-to-values above 80 percent. NAHB is concerned that FHFA's efforts to ensure the financial strength of mortgage insurers beyond reasonable measures may inadvertently harm the borrowers, taxpayers and the housing industry it is trying to protect.

<u>Impact of PMIERs</u>

NAHB believes mortgage insurers will charge borrowers higher PMI premiums if they must hold excess capital. Calculating available assets per the risk-based characteristics proposed in the draft PMIERs will dramatically increase the required capital that must be held and impact the cost of capital to such a degree that mortgage insurance premiums are almost certain to increase for all loans insured by PMI. Higher capital requirements will cause mortgage insurers to require higher mortgage insurance premiums from home buyers. Premiums are added to the borrower's monthly mortgage payment and therefore have a direct impact on mortgage affordability. Since it is often low-income and first-time home buyers who do not have the resources to make a 20 percent downpayment, thereby eliminating the PMI requirement, increasing the cost of PMI will disproportionately impact homeownership opportunities for these potential home buyers.

Though estimates vary, analysis by *Moody's Analytics* suggests the average premium across all PMI-insured mortgage loans would increase by 10 to 15 basis points. Insurance premiums on loans with higher risk factors, i.e. lower downpayments and lower credit scores, potentially would increase much more. The insurance premium on a 95 percent loan-to-value mortgage with a 700 credit score could increase between 20 and 25 basis points; a 95 percent loan-to-value mortgage with a 650 credit score might see an increase in the mortgage insurance premium 60 to 65 basis points.[1]

Under the proposed PMIERs, NAHB believes PMI premiums could increase enough that FHA financing would become more affordable for many home buyers who currently would qualify for conventional financing. This would increase the dependence of the market on fully government-insured mortgages when many, including NAHB, are calling for a decreased risk for taxpayers in the mortgage market and an increased role for private capital.

NAHB's "Priced Out Model" estimates the monthly payment on a 30-year mortgage would increase from $1,321 to $1,336 if mortgage insurance premiums rise by 10 basis points and to $1,344 if mortgage insurance premiums rise by 15 basis points. The minimum income required to qualify for a mortgage would increase from $73,382 to $74,031 and $74,356 respectively. As a result, roughly 500 – 700 thousand households would be "priced out" of homeownership.[2]

<u>NAHB Recommendations</u>

NAHB believes the following three proposed requirements in PMIERs should be amended per the proposed recommendations:

Future Premiums

<u>Requirement</u>
The draft PMIERs do not allow mortgage insurers to count revenue from insurance premiums as an available asset if the mortgage was originated after 2009.

<u>Recommendation</u>
A percentage of future insurance premiums should be counted toward available assets. Without counting future premiums toward available assets, mortgage insurers would have to increase capital significantly above current levels. Premiums are paid every year while a mortgage remains insured, so it is unreasonable not to count any portion of the premiums toward available

[1] Moody's Analytics, *Putting Mortgage Insurers on Solid Ground,* August 2014.

[2] NAHB bases these estimates on a median new home price of $275,000 with a 10 percent down payment; mortgage rate of 4.5%; and annual mortgage insurance premium of 45 basis points.

assets. Insurance premiums, discounted by some percentage to acknowledge that there will be prepayments, defaults, and other reductions in premiums collected, should be counted toward available assets.

As estimated in *Moody's Analytics*, counting some future premiums would significantly reduce the increase in average mortgage insurance premiums across all PMI-insured loans although premiums still would increase for higher risk borrowers. In the approach suggested in *Moody's Analytics*, a borrower with a 650 credit score and a 95 percent loan-to-value would still experience a 30 to 35 percent basis point increase, half of the estimated increase without this revision[3].

Loan Seasoning

<u>Requirement</u>
For loans originated after 2008, the risk factors to calculate required available assets remain the same for the life of the loan.

<u>Recommendation</u>
As a loan seasons and continues to perform, the risk factors should decrease to require less capital to be held against the loan. The longer a loan performs, the lower the risk of default and loss severity. This should be reflected in the calculation of capital.

Delinquent Loans

<u>Requirement</u>
Increased reserves are required for delinquent loans.

<u>Recommendation</u>
Delinquent loans should not have increased risk factors. The premise of risk-based pricing assumes already that the assigned risk factors include the potential that a loan may default. Assigning an additional reserve requirement for delinquent or non-performing loans effectively requires a mortgage insurer to hold capital twice for the same loan.

This requirement also will lead to mortgage insurers holding more capital during times of economic stress. Raising capital in times of stress is expensive and would require the mortgage insurers to increase premiums and reduce credit affordability when the industry needs lower costs and increased credit availability. This requirement places the mortgage insurance industry in a pro cyclical role rather than a counter cyclical role.

Enterprise Discretion

<u>Requirement</u>
The grids that FHFA has established to calculate the risk-based required available assets can be changed at the Enterprises' discretion.

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[3] Moody's Analytics, *Putting Mortgage Insurers on Solid Ground,* August 2014.

<u>Recommendation</u>
Modifications to the grids which impact the required available assets should not be left entirely to the discretion of the Enterprises. This introduces a level of uncertainty to the required available assets that might have the unintended consequence of encouraging mortgage insurers to raise insurance premiums to compensate for this uncertainty. Potential changes to the grid should be reviewed by FHFA with a requirement that the agency would assess the impact to the housing market before agreeing to modifications.

Conclusion

NAHB agrees that mitigating counterparty risk is an important factor in managing the safety and soundness of the Enterprises. The Enterprises are dependent on private mortgage insurers to absorb first-loss risk and they should have a high degree of confidence that these entities are acting responsibly both financially and operationally to manage the risk and hold capital to pay claims as promised. However, it is incumbent on FHFA and the Enterprises to find the appropriate balance between a capital requirement that ensures a well-capitalized mortgage insurance company and one that forces a mortgage insurance company to compensate for significantly higher capital standards by unnecessarily increasing the fees they must charge home buyers.

Thank you for your consideration of NAHB's comments. If you have questions, please contact Becky Froass, Director, Financial Institutions and Capital Markets, at 202-266-8529 or rfroass@nahb.org.

Sincerely,

David L. Ledford

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