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September 8, 2014

The Honorable Mel Watt
Director, Federal Housing Finance Agency
400 7th St SW, Ninth Floor
Washington, DC 20024

Re: Draft Private Mortgage Insurer Eligibility Requirements

Dear Director Watt:

Thank you for the invitation to comment on the *Draft Revised Private Mortgage Insurer Eligibility Requirements* (PMIERs).The following is the response from the Center for Community Capital at the University of North Carolina at Chapel Hill. The UNC Center for Community Capital conducts research on financial markets to help policy makers find sustainable ways to broaden economic opportunity.[1] Our research on homeownership finance has examined how risk factors, products and practices affect sustainability for households and lenders alike, particularly for low- and moderate-income households.

Private mortgage insurance (PMI) is the primary vehicle through which low down payment borrowers can participate in the conventional mortgage market. In particular, the charter of the government-sponsored enterprises (the "Enterprises") requires a credit enhancement for loans with loan-to-value (LTV) ratios over 80 percent. Historically, this has included nearly one-fifth of all Enterprise loan purchases. These borrowers are more likely to be low-and-moderate income, minority, young, and first-time homebuyers. For example, based on loan-level performance data of Fannie Mae purchases between 2000 and 2010, 21 percent of high LTV loans went to first-time homebuyers, compared to less than 7 percent of loans with LTV ratios of 80 percent or less. Consequently, private mortgage insurance is integral for many low-wealth borrowers to benefit from the "liquid, efficient, competitive, and resilient" market fostered by the Enterprises.

The federal support provided to the Enterprises over time (implicit and explicit) corresponds to their responsibility to the overall housing market to ensure the availability of safe, transparent, liquid and affordable mortgages to all creditworthy borrowers. By providing liquidity for mortgage credit on

[1] The UNC Center for Community Capital, www.ccc.unc.edu, is a university-based research center led by Dr. Roberto Quercia, which conducts analysis to help policymakers, advocates and the private sector find sustainable ways to expand economic opportunity to more people, more effectively. Janneke Ratcliffe has served as the Center's Executive Director since 2005, and brings mortgage market experience having previously working for GE mortgage insurance company and for a leading non-profit mortgage lender. Kevin Park is a doctoral candidate in the Department of City and Regional Planning at the University of North Carolina at Chapel Hill and has been a graduate research assistant at the Center since 2009.

good terms for families across a broad income spectrum, the Enterprises promote the long-term health and stability of the housing market. Further, the Enterprises have an explicit statutory mandate to pursue "activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities." The low downpayment segment of the Enterprises' business falls squarely into this aspect of their purpose.

Clearly, much hangs in the balance of how low downpayment lending is treated by the Enterprises via their approach to regulating the private mortgage insurance industry on the one hand, and Enterprises' own pricing for those same loans on the other.[2] The UNC Center for Community Capital has extensively researched the risks and benefits of low downpayment lending, particularly as facilitated by the Enterprises. Since 1999, the center has undertaken research on loans made to low- and moderate-income borrowers under the Community Advantage Program, a partnership between Self-Help, the Ford Foundation, and Fannie Mae. Our research confirms that low downpayment lending can and has been undertaken safely and soundly, provided that the borrowers are offered access to the same sound and efficiently priced products as traditional borrowers.[3] Our studies have examined how risk factors and lender practices determine sustainability for households and lenders alike.

Not only do we find that low downpayment lending to households of modest means can be safely and affordably achieved, we also find that it is critical to the health of our housing system and to household economic wellbeing to do so. Between 2003 and 2013, the black-white homeownership gap increased from 26.1 percent to 30.4 percent, the highest on record. Meanwhile, the homeownership rate for householders under 35 years old fell to its lowest level on record (35.9 percent as of 2014Q2). The PMIERs are central to the future of low downpayment lending, and thus to the future of homeownership in this country.

As a statutorily required form of credit enhancement on low downpayment mortgages, the PMI industry is an indirect beneficiary of the Enterprise-backed system. And as the preferred credit enhancement, the PMI industry is integral to the Enterprises' toolkit for achieving its statutory purposes. For the PMI industry to be effective, the PMIERs should:

1. Assure confidence in the PMI vehicle so that low downpayment financing is consistently available and resilient so that the Enterprises (and taxpayers) are adequately protected,
2. Provide for affordable, stable mortgage financing for low downpayment borrowers, and
3. Align the practices of the insurers with the public goals of the Enterprises and FHFA.

[2] FHFA has requested input and we have concurrently commented on the proposed pricing of g-fees (see Park and Ratcliffe 2014)

[3] See for example, Quercia, Freeman and Ratcliffe, Regaining the Dream: How to Renew the Promise of Homeownership for America's Working Families. Brookings Institution Press, Washington DC. For a summary of our decade of research on a national conventional affordable mortgage program demonstration, see *Community Advantage Panel Study: Sustainable Approaches to Affordable Homeownership,* at http://ccc.unc.edu/contentitems/community-advantage-panel-study-sustainable-approaches-to-affordable-homeownership/

Our commentary discusses how these can be achieved, and is followed by summary answers to select questions posed in your Request for Comment.

Confidence

The housing crisis exposed most private mortgage insurance companies as under-capitalized. All of the counterparties used by Fannie Mae and Freddie Mac and rated by one of the major credit rating agencies had ratings below the previous “AA-” standard for eligible mortgage insurance companies. Three companies (PMI Mortgage Insurance Co., Republic Mortgage Insurance Company, and Triad Guaranty Insurance Corporation) entered run-off under supervision of their state regulators, meaning no new business is endorsed, but claims continued to be processed, if partly deferred. At the end of 2013, the balance of deferred PMI payment obligations to the Enterprises stood at $2 billion[4]—versus a reported $42 billion in claims paid.

Understandably, the Enterprises want to avoid future shortfalls, particularly in the current structure where the inability of the Enterprises to build their own capital reserves means any shortfall could require another draw on Treasury funds. With full confidence in the value of the credit enhancement, the Enterprises’ pricing should be indifferent to higher LTVs and thus significantly reduced.

The approach proposed in the draft PMIERs will substantially increase the level of required capital for a given amount of risk in-force, lowering the risk-to-capital ratio from a ceiling of 25:1 to 18:1. Once additional risk-based factors are considered, the required risk-to-capital for current portfolios is an estimated level of 12:1.[5] As of March 2014, all mortgage insurers were close to or below 18:1, but none were below 15:1.[6] However, risk-to-capital ratios should continue to fall as credit conditions ease and a more normalized risk profile returns.

We believe the moderate increase in regulatory capital as a share of risk-in-force from 4.0 percent to 5.6 percent (a decrease in the risk-to-capital ratio from 25:1 to 18:1) is reasonable, but caution about being overzealous. Regulatory reform is not without its own risks. Higher capital requirements will translate into higher insurance premiums, compromising affordability.

Moreover, lower-risk borrowers may find optimal rates from lenders willing to hold their mortgage in portfolio or from a rejuvenated private label securities market. Mortgage insurance will only be sought for borrowers considered higher risk, often due to characteristics not observable to the private mortgage insurance companies. This problem of adverse selection may be particularly relevant if mortgage insurance is not adequately considered when setting the government-sponsored enterprises’ loan-level price adjustments.

[4] Zandi, Parrott and deRitis (2014)

[5] Zandi, Parrott and deRitis (2014)

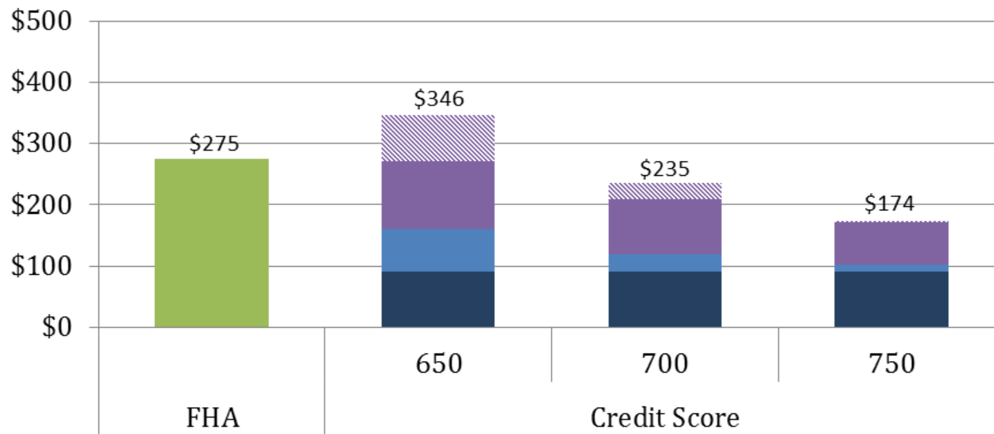
[6] Except NMI which as a new entrant had only $0.5B insurance in-force and a risk-to-capital ratio of 0.9. (Zandi, Parrott and deRitis, 2014).

Ironically, private mortgage insurance may lose market share at the other end of the credit spectrum as well. Higher costs in the conventional market might divert borrowers towards government-supported mortgage insurance programs in the form of the Federal Housing and Veteran's Administrations. UNC Center for Community Capital estimates that, after considering the combined costs of Enterprise guarantee fees and private mortgage insurance premiums, FHA is *currently* already less expensive for borrowers with less than a 680 credit score if they can make a five percent downpayment. Under current pricing, FHA would be less expensive to nearly nine percent of Fannie Mae's 2000 book of business, based on Fannie Mae's public loan-level performance database. According to Moody's Analytics, the new PMIERs are projected to increase PMI premiums by 10 to 15 basis points on average, and by some 70 basis points on 95 percent LTV loans with credit scores of 650.[7] Exacerbating matters further, FHA is exploring reducing some of its rates after having raised them to restore the MMIF to stronger footing. The charts below show how private mortgage insurance premiums are layered on top of the Enterprises' guarantee fees, increasing the total monthly cost to borrowers.

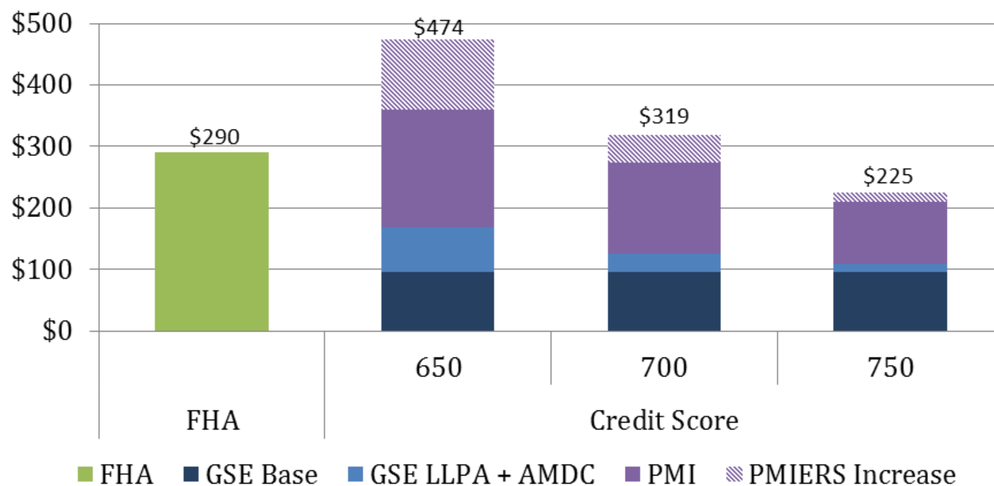
[7] Zandi, Parrott and deRitis (2014).

Estimated Monthly Insurance Cost for Home at Median Sales Price

90 Percent Loan-to-Value Ratio



95 Percent Loan-to-Value Ratio



Adapted from model developed by Genworth Financial and estimates from Zandi, Parrott and deRitis (2014)

With private mortgage insurance less competitive, the Enterprises might be forced to resort to less common, and less proven, credit enhancement practices to achieve affordable housing goals and pursue its mission of promoting access to mortgage credit throughout the Nation as stated in its charter.

Affordability

Overcapitalizing the mortgage insurance companies will compromise affordability. The proposed structure is also likely to discourage lending to certain creditworthy borrowers. A balance must be struck between confidence and access to credit. A few aspects of the draft eligibility requirements could be adjusted to safely improve affordability:

Balance confidence levels with affordability

Based on analysis developed by Mike Molesky and Mark Goldhaber, the capital provisions appear to aim for an excessively high confidence level. Because the underlying data and assumptions are not provided, it is impossible to ascertain this for certain, but the Molesky-Goldhaber analysis suggests an overabundance of caution. A reasonable but still conservative confidence level (99.5 percent is suggested) would likely reduce the cost implications.

Factor in cross-temporal cross-subsidization (seasoning)

The proposed rules should recognize that at any given point in time, an insurer's book of business is made up of many years' books of originations. When economic stress occurs, seasoned books will not experience the same default rates as newer books. This is one of the key efficiencies offered by well-diversified, long-term, institutional risk-takers. The appropriate method to adjust for seasoning and cross-temporal diversification can readily be determined by analysis of historical patterns.[8]

Distinguish purchase money mortgages from refinances

While we generally oppose risk-based pricing on borrower factors, loan characteristics such as purpose is a reasonable basis to distinguish pricing, particularly because of demonstrated better performance of purchase money mortgages vs rate and term refinances.[9] With credit losses on purchase money mortgages estimated to be roughly double those on refinances, this distinction would improve pricing for purchase mortgages materially, thus enabling the Enterprises to serve the important function of enabling entry into homeownership for more households.

Count Future Premium Revenue

Future premium income should be considered as a component of Available Assets (Question 31). Giving reasonable credit to future premiums is consistent with standard insurance practices and common sense. Fundamentally, the treatment of future mortgage insurance premiums is one of maturity transformation.[10] Zandi, Parrott and deRitis (2014) suggest several approaches for appropriately doing so. The resulting reduction in premium increases would be material, and depending on how implemented, could improve pricing the most for loans with slower prepayments, which are often associated with lower credit score, higher LTV, and weaker economic conditions.

If reasonable credit is not given for future premiums, one alternative may be for mortgage insurers to monetize future premiums. This might be done in a safe and sound manner, but the Enterprises would need to ensure that the exchange is sound and arms-length. As a related example, many mortgage lenders were surprised in the housing crisis from losses tied to liquidity puts and other contingent agreements to support nominally independent structured investment vehicles that had purchased their mortgages. It would be preferable to simply give some credit for the future premiums.

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[8] Molesky and Goldhaber (2014) estimate the magnitude of the seasoning benefit; Zandi, Parrott and deRitis (2014) offer suggested methods to adjust for it.

[9] See Molesky and Goldhaber (2014), and Park and Ratcliffe (2014).

[10] Similar to the steam of guarantee fees collected by the government-sponsored enterprises, which as noted by Goodman et al (2014), should be factored into the setting of g-fees.

Stability

Providing stabilizing and countercyclical financing goes hand-in-hand with affordability as an important function of the Enterprises, and by extension, the mortgage insurers they rely on to serve an important market sector. The PMIERs should seek to maximize countercyclical forces and minimize volatility. One area in particular where this can be achieved is in minimizing the extent of risk-based pricing faced by borrowers.

The UNC Center for Community Capital has raised concerns about risk-based pricing in financial markets which we lay out in detail in our commentary on the Enterprises' guarantee fees. In a nutshell, excessive risk-based pricing is destabilizing, pro-cyclical, complex and opaque, and particularly costly to lower-income and lower-wealth borrowers and communities. First, much of the high default rates associated with subprime mortgages are related to the quality of the mortgage products, not the borrowers that receive them. Low credit score borrowers with high LTV mortgages are three to five times more likely to default if given a subprime mortgage than a traditional, 30-year fixed-rate mortgage (Ding et al. 2011). Second, the higher price intended to cover the higher risk has the unintended side effect of increasing the likelihood of default by increasing the debt burden of any given level of debt. Instead of risk-based pricing, we generally favor pricing and capital requirements based on the average, pooled risk of a mortgage portfolio, consistent with basic insurance principles.

Nevertheless, risk-based capital requirements, which inevitably lead to risk-based pricing, are useful in forestalling adverse selection, which would ensure that losses from insuring high-risk loans do not jeopardize an insurer's ability to pay claims. However, the degree of risk-based capital should be constrained. In general, the 18:1 risk-to-capital ratio should be the more binding capital requirement. Any variation in capital requirements based on borrower risk should be justified by empirical evidence made publically available. Finally, risk-based capital requirements should be based on cycle-adjusted levels of risk. Increasing capital requirements due to higher levels of default in more recent vintages of loans during a housing downturn reduces the amount of credit available, which exacerbates the housing downturn and increases volatility.

Best Practices

The PMIERs offer an excellent opportunity to reinforce best practices for a holistic set of Enterprise objectives that relate to balancing access to credit with safety and soundness.

Loss mitigation for home retention and loss reduction

One of these opportunities brought up in the draft PMIERs is loss mitigation. Unfortunately, we have serious concerns about the proposed approach, whereby the Enterprises would pressure the mortgage insurers to fully delegate loss mitigation decisions. Mortgage insurance companies have a strong incentive to pursue loss mitigation actions that keep borrowers in their homes. By contrast, although the loss mitigation actions of Fannie Mae and Freddie Mac are noteworthy, the government-sponsored enterprises may find it financially advantageous to quickly foreclose on delinquent borrowers, safe in the knowledge that mortgage insurance will absorb much of the losses. Such a

strategy would actually reduce the soundness of the mortgage insurance company, when the alternative would keep borrowers in homes and reduce mortgage insurance claims.

The situation is similar to the "tranche warfare" that may have hindered loan modification in private-label mortgage-backed securities (Eggert 2007; Kiff and Klyuev 2009). It is also similar, as we understand it, to the way that the HAMP NPV model is more likely to favor foreclosure when there is mortgage insurance on the loan. Such unintended consequence of having purchased mortgage insurance should not be sanctioned by the Enterprises.

Consequently, we believe that mortgage insurance companies should not be penalized by pricing adjustments for not delegating loss mitigation activities to the government-sponsored enterprises. Instead, the government-sponsored enterprises should provide guidance and oversight for the mortgage insurance companies in best practices, and the enterprises should monitor the mortgage insurance companies for excessive losses. We suggest a joint decision making approach whereby either the mortgage insurer or the Enterprise could opt for an alternative to stay foreclosure, but both would have to agree to a foreclosure.

Mortgage insurance public disclosure

Most mortgage lenders are required under the Home Mortgage Disclosure Act (HMDA) to submit information detailing information on loan applications received, including the location (census tract), borrower income, race/ethnicity, loan purpose (purchase or refinance) and lender action (whether the application was denied or loan originated), etc. This database is intended "to provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located and to assist public officials in their determination of the distribution of public sector investments in a manner designed to improve the private investment environment" (12 USC § 2801). Since 1993, private mortgage insurance companies have also submitted information to the Federal Financial Institutions Examination Council in a similar format as that required of lenders under HMDA; however, reporting is voluntary. While rule-making authority for HMDA was transferred to the Consumer Financial Protection Bureau in 2011, FHFA could make reporting to the Federal Financial Institutions Examination Council mandatory of private mortgage insurance companies in the PMIERS. Transparency is vital for public discussion. The institutionalized role private mortgage insurance has in our housing finance system means it should be subject to the same public disclosure requirements as mortgage lenders.

Other practices for safely expanding access to credit

We encourage the incorporation of broader oversight into the PMIERs. The PMI companies are indirect beneficiaries of the housing finance system created by the Enterprises to further their public mission. PMI companies should thus share in accountability to the Enterprises' duty to serve responsibilities. Rather than prescribe these provisions in detail at this point, we simply, but strongly, encourage you to use this opportunity to build a new and better set of standards that would cover such possible areas as:

- Participation in serving underserved markets consistent with responsible practices, to help advance housing goals, duty to serve objectives and, where applicable, lenders' CRA responsibilities.
- Fair lending compliance and reporting.
- Consumer-friendly pricing, including moderation of the complexity, range and opacity of risk-based pricing.
- Implementation of risk mitigation techniques such as full-cycle homeownership counseling.
- Innovative product development to test new ways to expand access safely.
- Demonstrating efforts and investments to improve outreach to underserved markets.
- Support of preventive servicing activities by servicers.

These examples are given to illustrate the potential scope of options for operationalizing the PMI's responsibilities to help achieve the Enterprises' purposes while maintaining safety and soundness.

Selected Question & Answers

Below, we provide summary responses to some of the questions raised in the request for input.

Question 1B. How can the PMIERs ensure that potential losses form insuring high-risk loan concentrations do not jeopardize an Approved Insurer's ability to pay claims on its lower risk portfolio?

Some managed level of risk-based capital requirements, inevitably leading to risk-based pricing, can forestall adverse selection such that losses from insuring high-risk loans do not jeopardize an insurer's ability to pay claims. Nevertheless the PMIERs should seek to moderate the complexity, range and opacity of risk-based pricing to consumers.

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

Absolutely. The PMIERs offer an excellent opportunity to reinforce best practices for a holistic set of Enterprise objectives that relate to balancing access to credit with safety and soundness. We list several examples.

Question 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?

Certainly not. Mortgage insurance companies should not be penalized for not delegating loss mitigation activities to the Enterprises. We propose an alternative approach that favors foreclosure alternatives and does not weaken mortgage insurers and communities through unnecessary foreclosures.

Question 17: What comments or suggestions are there related to including LTV and credit score as the primary factors in the grid framework for performing loans?

Our comments relate to the risks of risk-based pricing. While some risk-based pricing is unavoidable, the PMIERs should seek to moderate the complexity, range and opacity of risk-based pricing to consumers, particularly when based on borrower factors. On the other hand, we encourage differentiation by loan products, such as purchase or refinance.

Question 20: Is the segregation of books of business by vintages appropriate?

The proposed rules should recognize that an insurer's book of business is made up of many years' books of originations. Inter-temporal risk pooling

Question 25: What are the merits or drawbacks of having several DTI multipliers?

While we did not address this in our commentary, research clearly shows that DTI is poor predictor of risk. Moreover it is hard to calculate with the extreme precision implied by having small ranges as proposed. Finally, DTI is extremely variable; a borrowers' debt-to-income ratio is constantly in flux. For these reasons we recommend against the use of DTI multipliers.

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

Future premium income, with some adjustments, should be considered as a component of Available Assets.

Questions 40-42 combined: What may be the impact, if any, on high LTV borrowers, low credit score borrowers, and seller/servicers of the draft PMIERs?

The higher capital charges proposed for lower credit score borrowers and higher LTV borrowers will result either in the mortgage insurers reluctance to serve such borrowers, or a substantial increase in costs of credit for such borrowers, or both. The result will be fewer loans to underserved markets, somewhat offset by more lending going through FHA. This would particularly affect depository lenders whose CRA obligations would become harder to meet without a conventional secondary market takeout.

Conclusion

The modern private mortgage insurance industry has been around since 1957 and is built into the American housing finance system by the requirement for credit enhancement on high LTV mortgages in the charters of the Enterprises. Through ups and downs in the housing market, mortgage insurance has ensured (and insured) the continuing availability of low downpayment conventional mortgages vital for first-time homebuyers and many underserved borrowers. Similar to many participants in the mortgage market, private mortgage insurers have suffered large losses in the most recent downturn, the worst since the Great Depression. Still, insurers have reimbursed the government-sponsored enterprises approximately $42 billion since they entered conservatorship.

Reforms to the private mortgage insurer eligibility requirements used by the Enterprises are important to ensure the financial claims-paying ability of insurers in times of stress, but should also

consider the effect on profitable low down payment mortgage lending and sustainable homeownership among wealth-constrained Americans. Moreover, the PMIERs should go beyond basic questions of capital adequacy to implement a more holistic arrangement with the Enterprises.

Thank you for the opportunity to share these comments and for your consideration.

Sincerely

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