Mortgage Insurance Companies of America

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Attention: Comments/RIN 2590-AA40

Dear Mr. Pollard:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the advance notice of proposed rulemaking (ANPR) issued by the Federal Housing Finance Agency (FHFA) on alternatives to the use of credit ratings in the federal regulations governing Fannie Mae, Freddie Mac and the Federal Home Loan Banks.[1] MICA recognizes that FHFA, like other federal agencies, has been charged with a complex task under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[2] which mandates the deletion of references to credit rating agency (CRA) determinations as a basis for regulatory determinations of creditworthiness. MICA has long argued against undue reliance on CRA determinations, which proved highly problematic throughout the run-up to the current financial-market crisis and which may yet lead to systemic and counterparty risk despite the numerous reforms mandated by the new law. However, we are concerned that the new risks that would result from simple deletion of CRA references in FHFA rules and unquestioned reliance on internal models or other determinations by the regulated entities subject to FHFA (which shall generally be designated as GSEs below). We thus here comment on FHFA's ANPR and the specific questions posed to suggest an initial regulatory framework to meet the requirements in the new law without creating new risks. We recommend that FHFA join with the other federal financial regulators to craft the more complete credit-risk analytical framework to replace CRAs, which we fear cannot reasonably be finalized in compliance with the Dodd-Frank Act deadline. The regime we suggest below and any now adopted by FHFA should be deemed interim, perhaps codified as an interim final rule, to make clear that additional work in this important area is forthcoming. MICA pledges to work with FHFA in this important endeavor.

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[1] *Alternatives to Use of Credit Ratings in Regulations Governing the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Federal Home Loan Banks*, 76 Fed. Reg. 5,292 (Jan. 31, 2011).

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

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MICA is the trade association of the U.S. private mortgage insurance (MI) industry. MICA members have a strong interest in CRA methodology and use and we have thus provided extensive support for efforts by the Securities and Exchange Commission (SEC) and the bank regulators in this area.[3] We also provided initial views on CRA concerns in connection with a request for views on this topic by the FHFA related to the joint-and-several liability of the Federal Home Loan Bank System.[4]

As the ANPR notes, one of the references to CRAs in FHFA regulations directly pertains to reliance on MI by the Federal Home Loan Banks.[5] It is our understanding that several of the Home Loan Banks have suspended purchases of mortgages with private mortgage insurance notwithstanding the valuable third party credit enhancement that MI provides, due to confusion over the best way to assess credit-risk for products bearing private mortgage insurance. Given the proven claims-paying capacity of MICA members, all of which continue to pay claims and meet their obligations, this approach actually serves to weaken the financial well being of FHLBs since they are unable to look to third parties to mitigate potential losses. In this regard, we note that MI has been critical in reducing the cost to taxpayers of the conservatorship of Fannie Mae and Freddie Mac, paying $22 billion in claims and receivables to the enterprises that would otherwise have had to be borne by taxpayers.

Likewise we will continue to honor our obligations on valid claims presented by Home Loan Banks have and will be similarly honored. There is thus no reason for the Banks to cease reliance on private mortgage insurance. Doing so will unnecessarily put further strain on already-stressed capital resources in the Home Loan Bank System and limit the System's access to third party capital and its capacity to support mortgage-market recovery. We thus urge FHFA quickly to issue clarification to the Home Loan Banks reminding them that MI is a permissible form of credit risk mitigation, based on the rigorous state-regulatory framework outlined below. We also urge FHFA to make public any substitutes FHLBs may employ in lieu of MI so that public disclosure may inform FHFA about potential, increased credit risk.

All of the Home Loan Banks should have in place appropriate standards to assess their credit-risk counterparties like MIs. Should this not be the case, FHFA could adopt an approach under consideration by the National Credit Union

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[3] See for example, MICA, comment on *Credit Rating Standardization Study*, 75 Fed. Reg. 80,866 (Dec. 23, 2010); 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; 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 *Federal Home Loan Bank Liabilities*, 75 Fed. Reg. 68,534 (Nov. 8, 2010).

[5] 12 C.F.R. 955.3(b)(1)(ii) (2010).

Administration (NCUA),[6] which permits credit unions to judge credit risk based on appropriate internal policies and procedures.

Based on these views, MICA is now pleased to answer questions posed in the NPR germane to private mortgage insurance. As noted, we look forward to working with FHFA to refine the approach to replacement of CRA determinations with a framework of credit-risk analytics used by the GSEs and FHFA that properly differentiates relative credit risk in a transparent, objective and sound fashion. Key points discussed below are as follows:

- The "core principles" proposed for replacements to CRAs should include an additional one that recognizes the value of robust, capitalized credit risk mitigation in providing double-default protection. Quite simply, a GSE takes less credit risk when an initial position is insured by an MI or similar entity with ample capital under effective regulation than when a comparable position is taken without this credit-risk protection. Recognition of this additional principle supports the others articulated in the ANPR (e.g., meaningful risk differentiation, lack of burden, transparency). MICA believes that FHFA may reflect GSE determinations of eligible credit risk mitigation when criteria to ensure true risk protection are met, and we below detail these criteria. Critical among them is capital adequacy and coverage by a robust regulatory regime on which FHFA may rely. To facilitate consideration in this area, we detail key aspects of current state regulation of private mortgage insurance.

- We believe that reliance on the presence of credit risk mitigation as long as it is provided by a well-capitalized and strongly regulated entity, should be deemed as a favorable factor in evaluating creditworthiness is transparent and objective. It thus accomplishes FHFA's stated objectives as an initial step towards compliance with the requirements of the Dodd-Frank Act. MICA members' expertise on mortgage credit assessment and mitigation provides a protection measure that other forms of credit enhancement may not have. MICA pledges to provide additional analytics to support revisions to the risk-based capital rules now required due to deletion of capital determinations based on ratings from the nationally-recognized statistical ratings organizations (NRSROs).

We recommend that FHFA defer establishment of qualitative or quantitative standards that replace CRA determinations at the present time, but continue to develop these so that, over time, the replacement methodology meets the core principles addressed above.

[6] *Removing References to Credit Ratings in Regulations; Proposing Alternatives to the Use of Credit Ratings*, 76 Fed. Reg. 11,164 (Mar. 1, 2011).

I. Principles for a New Approach

The ANPR states that FHFA proposes the following principles for the methodology to replace CRA reliance:

- accurate and meaningful credit-risk differentiation;
- transparency;
- consistency of application across GSEs when subject to the same standards;
- lack of burden and "straightforwardness"; and
- lack of susceptibility to manipulation.

MICA supports these principles. However, the ANPR rightly notes that a final CRA-free regulatory regime may require trade-offs among these principles and seeks views on several additional questions in this area.

A. Core Principles

MICA supports all of these principles, but we believe there will be fewer trade-offs among them if FHFA recognizes the relative value of any position with MI versus one without MI or a comparable form of regulated, capitalized credit risk mitigation (CRM). Provisions that will remain unchanged in Basel III[7] that are included in the Basel II rules[8] and the U.S. final rules implementing the advanced internal ratings-based standards in Basel II[9] recognize (with limits) the value of CRM in providing "double-default" coverage. That is, The Basel standards concur that, when there is a robust form of CRM, a counterparty like a GSE is insulated from credit risk because it absorbs no loss unless two events occur: first, the obligation on which CRM is placed must default and, then, the CRM provider must fail to pay a claim. The simple fact of CRM thus prevents the immediate loss upon default that would otherwise occur and makes far less likely any resulting credit risk other than that not initially protected by the CRM.

Based on this, MICA recommends an additional core principle:

- Presence of a well regulated, robust, capitalized form of credit risk mitigation that ensures meaningful double-default protection.

In evaluating CRM providers, FHFA should recognize the robust risk management, coupled with regulatory capital and reserve requirements and regulatory

[7] 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.

[8] Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version* (June 2006), paragraphs 195 and 302, *available at* http://www.bis.org/publ/bcbs128.pdf.

[9] See the applicable treatment in the OCC's regulations, 12 C.F.R. Part 3, Appendix C, Section 2 (2010).

oversight that uniquely position MIs as reliable, prudent counterparties. Review of authorized CRM should assess:

- dedicated, highly-liquid capital and reserves;
- capital adequacy under specified stress scenarios;
- differentiated capital requirements for current versus delinquent mortgage obligations;
- transparency of the criteria of the models used to establish eligibility;
- lack of correlation between the risk of the instrument covered by the provider of credit risk mitigation and that of the provider itself. This is accomplished at MI firms (as discussed in more detail below) through strict limits on the ability of MIs to invest in obligations that bear risk comparable to those of the mortgages insured by the MI. Correlation risk undermines the ability of a CRM to pay claims under stress; and
- active regulatory oversight.

B. State Regulation of the Safety and Soundness of MIs

Mortgage insurance companies are subject to a comprehensive web of financial regulations and oversight activities by their state insurance commissioners in both the states in which they are domiciled and those in which they do business, that address capital and investments, loss reserving, financial condition and product rates and restrictions. Together, the insurance laws and regulations, along with the mandated supervisory activities of the state regulator, provide a strong financial oversight process to ensure that the MI operates in a stable and secure manner for the benefit of its policyholders.

State insurance laws establish minimum capital and surplus requirements for a mortgage guaranty company in addition to minimum policyholder position requirements to ensure that companies maintain a sufficient capital position to be permitted to continue transacting insurance. Mortgage insurer investments are limited and the ability of the company to issue dividends is also subject to regulatory review and approval. The requirements that apply to mortgage insurers are in addition to or supersede the comprehensive insurer financial provisions and procedures applicable to all insurers domesticated in the state. Mortgage guaranty insurance is also required to be written on a monoline basis to ensure the clear financial stability of the mortgage insurance business written.

MIs are required to maintain contingency reserves equal to fifty percent of net unearned premiums for a period of ten years or until approved for release by the state insurance commissioner. Contingency reserves provide an extra capital cushion, which greatly increases the ability of MIs to withstand periods of increased claims due to stress in the general economy and/or housing markets. Recent experience demonstrates the effectiveness of this requirement.

MIs are also required to maintain miscellaneous reserves (for the amount of additional reserves required by the laws of others states in which the MI operates), unearned premium reserves and premium deficiency reserves. State insurance laws restrict reinsurance of mortgage guaranty business, limiting the companies to which a mortgage insurer may cede business, and requiring licensing, reserves, and other solvency requirements to be satisfied. Insurers are further required to file reports on its reinsurance agreements as part of its quarterly and annual financial statements.

The policy forms and premium rates set by the MI are subject to review and approval by the insurance commissioner in certain states. The rate review standards are typically to ensure that the rates applied are not excessive, inadequate (such that the rate is insufficient to sustain projected losses and expenses and so may impact insurer solvency), or unfairly discriminatory.

To ensure that every domestic mortgage guaranty insurer is operating in compliance with state law, the state regulator is required to conduct a financial examination of each domestic insurer. The National Association of Insurance Commissioners ("NAIC") provides state regulators a forum to establish model examination and financial reporting standards and to share financial and market conduct compliance information regarding insurance entities, promoting the application of consistent regulatory and financial oversight requirements among the states. State regulators can suspend or revoke the license to transact insurance for any company deemed to be in hazardous financial condition.

States in which MIs are domiciled have adopted Hazardous Financial Condition regulations based on the Model Regulation promulgated by the NAIC. Under these regulations, MIs are subject to a range of criteria, which may indicate that the MI is in a financially hazardous condition. A number of actions may be taken if it is determined that an insurer is in a hazardous financial condition, including, but not limited to, orders to reduce or suspend new business, increase capital and surplus, or obtain reinsurance. These regulations act as an early warning system to detect and impose remedial actions on insurers well before they are threatened by insolvency.

II. CRA Alternatives

As an initial matter, MICA recommends that FHFA establish an overall approach to replacing CRAs with reliance on credit-risk determinations when CRM meets the criteria stipulated above as validated by FHFA examination. We recognize that this approach may not be truly transparent except with regard to reliance on CRM that meet specified criteria, but we think it is an important initial step that will both meet the statutory mandate of the Dodd-Frank Act and protect the GSEs from undue credit risk. MICA pledges to work with the FHFA to develop additional measures of credit risk to support the more nuanced requirements of the risk-based capital rules governing Fannie Mae, Freddie Mac and the Federal Home Loan Banks, as well as the criteria that dictate permissible investments by the Home Loan Banks.

III. Standards for CRA Alternatives and Risk Based Capital Requirements

As noted, MICA believes that criteria to ensure true risk protection are found in the regulatory oversight of MIs along with regulatory capital and reserve requirements and that these criteria currently protect the GSEs. At this point, MICA opposes direct FHFA standards in lieu of CRAs because of the complexity of crafting such a replacement methodology for credit risk in the short time provided for doing so. Instead, the risk-based capital rules should differentiate between CRM provided by firms that meet the standards outlined above that apply to mortgage insurance and those that do not (i.e., firms that lack capital and the other prudential standards that ensure claims-paying capacity under stress).

IV. Coordination with Other Regulators

In answer to question 8, MICA submits that it is important for FHFA to conform its credit-risk determination methodology and standards to those being adopted by the banking agencies as mandated by the Dodd-Frank Act to the greatest extent possible. Failure to do so could result in unanticipated risks to one or all of the GSEs because regulatory credit-determinations that differ among comparable parties may well create opportunities for regulatory arbitrage. While a risk difference may seem minimal, it can turn highly problematic quickly if a regulated institution exploits market developments that affect pricing or other factors resulting from varying credit-risk regulation. In this regard, it is particularly important for FHFA to work with the banking agencies and SEC to ensure a consistent approach to credit risk for mortgage-related obligations so that regulatory-arbitrage opportunities are addressed not only at Fannie Mae, Freddie Mac and the Home Loan Banks, but also at banking organizations and other mortgage investors to avoid the inadvertent creation of opportunities for regulatory arbitrage.

V. Conclusion

MICA pledges to work with FHFA and other regulators to craft a replacement methodology for CRA reliance that meets the goals outlined above. In the interim, we urge FHFA to ensure that credit risk mitigation meets the capital, prudential and related criteria detailed above.

Sincerely,

Suzanne C. Hutchinson