Systemic - #10

Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

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Mr. Robert S. Seiler Jr.
Manager of Policy Analysis
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Fourth Floor
Washington, DC 20552

Dear Mr. Seiler:

The Mortgage Insurance Companies of America (MICA) is pleased to respond to the request from the Office of Federal Housing Enterprise Oversight for views on whether Fannie Mae and Freddie Mac present systemic risk. MICA is the trade association for the nation's private mortgage insurers. As such, we have a keen interest in the future of the housing GSEs. We believe OFHEO should follow policies that ensure a certain and sound future for Fannie Mae and Freddie Mac, which means that the risks these enterprises take should be only those clearly intended by their charter and supported by sufficient capital. Properly confined to their mission and appropriately regulated, any risks the GSEs run will adhere to the benefit of the nation's housing system and thus comport with the mission for which the enterprises were created.

Throughout our comments, we will emphasize the importance of risk mitigation. Because of the huge size, exposure to catastrophic risk, and minimal capital that characterize the housing GSEs, it is essential that they make full use wherever possible of reliable risk mitigation measures. Thus, we believe the GSEs should not be allowed to take unnecessary credit risk given the existence of private mortgage insurance and other charter-approved ways to handle the risks of high-LTV mortgages.

727 15th St., N.W.
12th Floor
Washington, D.C. 20005
(202) 393-5566
Fax (202) 393-5557

Summary

The following summarizes MICA's views:

- While we are not able at this time to quantify the specific systematic risk posed by the GSE's we do have thoughts with respect to the overall risk profile. However, it is clear that, by virtue of their size and minimal capital, the GSEs warrant close and careful supervision, as well as confinement to a carefully defined mission.

- OFHEO can and should use its safety-and-soundness authority to limit activities of the GSEs that raise their risk profile and, thereby, increase the prospect that Fannie Mae and Freddie Mac pose a systemic risk.

- Recent GSE ventures into mortgage risk self-insurance significantly increase the exposure of these enterprises to catastrophic risk. They should be curtailed.

- The large portfolios held on the books of the GSEs create serious concerns about the magnitude of the interest-rate risk profile of the enterprises. The very large portfolios of retained MBS exacerbate this risk and do not contribute to the GSEs' mission of promoting home ownership. OFHEO should strictly limit GSE investments only to those necessary to ensure adequate liquidity.

I. GSE Systemic Risk

As noted, MICA is not prepared at this time to comment on whether Fannie Mae and Freddie Mac pose a risk to the nation's financial system or, as OFHEO has proposed to define systemic risk, even more broadly to the nation's macroeconomic outlook. However, we do not believe that it is necessary to answer the question of systemic risk definitively to calibrate OFHEO's supervisory policy. With on- and off-balance sheet assets now equal to $2.3

trillion, it is indubitably clear that Fannie Mae and Freddie Mac are very, very large. With capital of only $33 billion backing this risk, it is also clear that these agencies are very highly leveraged. Their systemic risk impact would depend on whether they were subject to a sudden shock or if, under stress, the firms slowly contracted in size. Different scenarios clearly affect which of these courses a GSE under financial pressure would follow, so we believe it is incumbent on OFHEO to supervise the GSEs to minimize the possibility that problems at these massive enterprises would be unanticipated by financial markets.

In our view, the posture the federal financial regulators take with regard to systemic risk at major financial services firms may be appropriate with regard to the GSEs. Reflecting the difficulty of determining whether problems would create market risk, bank regulators follow the practice of "constructive ambiguity." They avoid any public statement that a large bank is a potential source of systemic risk to avoid creating market expectations that such an institution is too big to fail. Too-big-to-fail expectations create moral hazard because market participants expect regulators to bail out such companies, inducing them to disregard early warning signs of incipient risk at such companies. The policy of constructive ambiguity keeps market participants on their toes because of uncertainty about whether a big bank or similar financial services firm would be supported by regulators. This market discipline in turn not only provides regulators with early warning signs of problems, but also reduces the cost of failure when federal assistance is required.

Federal bank regulators prefer to promote policies that ensure that no bank is "too big to liquidate," instead of focusing on how to address too-big-to-fail banks. We urge OFHEO to consider a similar approach for the housing GSEs. A regulatory policy that ensures an orderly disposition of a troubled GSE will ensure that Freddie Mac and Fannie Mae do not pose systemic risk. As discussed in more detail below, MICA believes OFHEO has the statutory authority to prevent the GSEs from engaging in activities that would make it more difficult to liquidate the enterprises in an orderly fashion, and we urge

OFHEO to make use of this authority to prevent the prospect of systemic risk from ever becoming a reality that in fact adversely affects the nation's macroeconomic prosperity.

II. OFHEO Authority

MICA concurs with the interpretation of OFHEO's statutory authority expounded in the September 7, 2000 memorandum prepared by OFHEO counsel in response to Freddie Mac's investment in HomeAdvisor Technologies Incorporated. In that opinion, OFHEO counsel reached the conclusion that OFHEO's safety-and-soundness authority gives the agency clear and dispositive power to condition, contain or cease any activity in which Fannie Mae or Freddie Mac engages that poses an undue risk.

In the September 7, 2000 memorandum, OFHEO counsel correctly compares OFHEO's supervisory authority to that granted to the bank regulators, reaching the conclusion that Congress intended OFHEO to be as thorough and effective a safety-and-soundness regulator as the Federal Reserve, OCC, OTS and FDIC. Indeed, OFHEO has implemented this understanding of its supervisory power in its examination methodology, as detailed in the examination handbook dated December 1998. In that handbook, OFHEO makes it clear that it will examine the GSEs on the same risk-based matrix used by the federal financial institution regulators. This matrix includes not only traditional financial risks (e.g., asset quality), but also "legal," "reputational", "compliance" and "strategic" risks. It is clear that a review of GSE programs to determine how they rate on these risk parameters is essential to effective supervision not only according to OFHEO's standards, but also to those used by all the other federal financial agencies. It would be a contrary and perverse result if OFHEO could not limit an activity deemed to pose any of these risks once such an operation had been uncovered in an examination or otherwise brought to OFHEO's attention.

As noted above, MICA believes that the most important way OFHEO can limit or prevent the GSEs from presenting systemic risk is to regulate them effectively, ensure that they are adequately capitalized and limit their activities only to those specified in the GSE charters so that no unnecessary or inappropriate risks are taken. OFHEO should also mandate use of third-party capital to backstop GSE risks wherever this is feasible.

III. Specific Risk Concerns

As noted above, MICA believes an important element in preventing systemic risk is ensuring that the GSEs take only those risks dictated by their charters and for which the GSEs have ample and adequate capital and risk management structures in place. Where third-party capital is at hand to limit GSE risk, the GSEs should be required to use it. Creating revenue opportunities that present undue risk exposure or involve charter violations should not be permitted.

A. GSE Self-Insurance

MICA is particularly concerned with several recent programs in which the GSEs have substituted self-insurance for the bona fide third-party credit enhancement mandated in their charters. As OFHEO is aware, the GSEs' charters require that they obtain one of three forms of approved third-party protection when loans with LTVs above 80% are purchased. Private mortgage insurance (MI) is the principal form of credit risk mitigation employed by the GSEs. Despite this specific statutory injunction, the GSEs have been developing a variety of forms of self-insurance for the risk associated with high-LTV mortgages.

1. Delivery Fee programs

The first type of self-insurance developed by the GSEs can be characterized as delivery-fee programs. Under them, the GSEs reduce the amount of mortgage insurance obtained by lenders on behalf of borrowers, substituting their own self-insurance for bona fide third-party protection. The GSEs collect fees paid by consumers. They can then decide whether or not to obtain additional mortgage insurance, using the consumers' fees to pay for any such coverage.

These programs pose a threat to the GSEs' core capital. In a 10-year recession scenario (following a five-year period of economic prosperity in which the GSEs' delivery fee programs methodically penetrate the high-LTV market), we estimate that the GSEs would lose $3.42 for every $1 of earned delivery fees. The delivery fee programs under this scenario would drain approximately $7.1 billion in core capital from the GSEs over a 10-year recession scenario. Further, this capital loss would come at a time when other losses, such as balance sheet and operational losses, would also be taking their toll on core capital.

2. Investor-Paid MI

In a second very recent program (known as the "investor-paid" program), Fannie Mae is taking on even more unnecessary risk than it does under the delivery fee programs. Fannie Mae has done away with any insurance coverage on an individual mortgage and instead simply requires the borrower to pay a higher interest rate. Fannie Mae then buys some mortgage insurance at the time it purchases the loan, but we believe it acquires only the barest amount of third party MI.

Further, it also appears as if Fannie Mae does not include protection for the costs associated with foreclosure or unpaid interest and other disposition expenses, which typically amount to 15 percent of the unpaid principal balance of the loan. These expenses have traditionally been covered by mortgage insurance.

The omission of MI to cover disposition expenses could prove disastrous. Industry experience in the 1980s and 1990s has shown that losses can be severe and widespread, as demonstrated by the regional housing market troubles in California and New England in the early 1990s. For example, home values in Los Angeles declined nearly 30 percent between 1990 and 1996. In Hartford, home values declined more than 20 percent from 1990 to 1994.

With no protection for disposition expenses and only the barest minimum protection for default risk, the investor-paid MI program thus exposes the GSEs to unacceptable risks. Historically, the GSEs have obtained MI coverage down to LTVs of 75% or below to protect themselves from these risks. With the investor-paid program, that protection does not exist and the prospect for GSE loss is therefore significantly increased.

B. GSE Portfolio Operations

As noted above, MICA supports safe and sound GSEs able to conduct their necessary secondary market operations through good times and bad. We are therefore concerned by the huge size to which the GSEs' on-balance sheet portfolios have ballooned in recent years. Unless OFHEO carefully constrains these arbitrage operations, the GSEs' systemic risk profile will surely increase.

As of September 2000, the GSEs' combined retained portfolios of mortgage and MBS assets had grown to $933 million. Although the agencies hedge this risk, it is impossible for them to hedge it perfectly. Both Fannie Mae and Freddie Mac have, from time to time, suffered paper losses with regard to their huge books. In 1999, Freddie Mac was forced to reduce its book value by $331 million as a result of hedging losses. Earlier this year, Fannie Mae avoided recording a loss only by engaging in offsetting transactions after Treasury Under-Secretary Gensler's testimony in March unsettled the agency debt market. The imposition of FAS-133 will expose the GSEs to even more earnings volatility as a result of their derivatives operations, since the new accounting standard requires more transparent reporting of the impact on equity and income of the changing value of derivatives positions. Fannie Mae has stated that it will not reduce the amount of risk it hedges because of FAS-133, but there is no assurance that it or Freddie Mac will not come to do so as market conditions change. To the degree that reliance on derivatives increases the exposure of the GSEs to market volatility, their systemic risk profile increases.

The risks of these huge portfolios might be warranted if they promoted the GSEs' congressionally mandated mission of promoting home ownership. However, we view them as simple arbitrage plays in which the GSEs use their government-sponsored status and the resulting reduction in funding costs to hold huge books of higher-yielding assets. Thus, the risks of the portfolios support shareholder returns, but not home ownership, which would be as well served if the GSEs did what Congress intended in terms of securitizing mortgage assets instead of holding large volumes of whole loans or repurchased MBS on their books.

Stated differently, the portfolios of MBS held by the GSEs are even less defensible from a mission point of view, and they raise serious risk concerns. Both Fannie Mae and Freddie Mac now hold on their own books approximately thirty percent of the total amount outstanding of the securities they guarantee. As CRS has observed, "While it is clear that [the repurchase of mortgage backed securities] increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets."

MICA urges OFHEO to use its supervisory authority to prevent the GSEs from taking unnecessary interest-rate risk in the form of huge on-balance sheet portfolios. Without these portfolios, the GSEs would be far smaller. They would also have far less exposure to sudden market shifts in the value of derivatives, because smaller on-balance sheet portfolios would require far less reliance on derivatives. Thus, OFHEO should consider using its statutory authority to limit GSE portfolios not only to reduce their interest-rate risk profile, but also to guard against the possibility of systemic risk.

IV. Conclusion

MICA is not prepared at this time to provide OFHEO with a definitive statement as to whether the GSEs pose a systemic risk present systemic risk. However, we urge OFHEO to use its statutory authority to ensure that the GSEs take only those risks necessary to conduct their secondary market operations. Effective use of existing statutory authority will ensure that the GSEs could be liquidated in an orderly fashion should one or both encounter difficulties. Key to limiting the GSEs' risk profile is ensuring that they rely on third-party capital to the greatest degree possible pursuant to their charters when they do take risks. Thus, the GSEs should be barred from self-insuring the risks associated with high-LTV loans and their massive portfolios should be reduced to only that necessary to protect their liquidity.

MICA would be pleased to provide any additional information that might be helpful in examining the question of GSE risk. The Office may make this letter public should it wish to do so.

Sincerely,

Suzanne C. Hutchinson