Notice of Reg. Review - #3

Mortgage Insurance Companies of America

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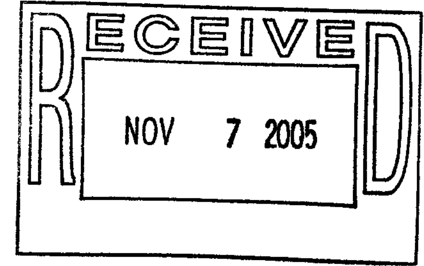

November 7, 2005

Mr. David A. Felt
Acting General Counsel
Office of Federal Housing Enterprise Oversight
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Attention: Comments/Notice of Regulatory Review

Dear Mr. Felt:

The Mortgage Insurance Companies of America (MICA) is pleased to respond to your request for areas that should be addressed in a new round of rulemaking by the Office of Federal Housing Enterprise Oversight (OFHEO). We are very appreciative of your interest in continuing to review OFHEO rules and, where necessary, addressing emerging risks to ensure that they do not go unnoticed and, over time, threaten not only Fannie Mae and Freddie Mac, but also the vibrancy of the overall mortgage market.

As recent history has shown, OFHEO cannot rely on internal risk management and effective corporate governance within the government-sponsored enterprises(GSEs). Market discipline is also ineffective for two reasons: first, as recent history has proved, the market does not discipline the GSEs because of their implicit guarantee; second, the lack of current audited GAAP financial results, accompanied by a thorough management discussion and analysis, means little is known about what the GSEs now may be doing. It is thus critical that, following the close of its review of potential regulatory options, OFHEO move quickly to

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implement additional safeguards through speedy public comment periods.

MICA believes the following are particularly urgent OFHEO regulatory initiatives that can and should be quickly consummated under current law:

- Fannie Mae and Freddie Mac should be required to comply with the loan-to-value (LTV) requirements pursuant to 12 U.S.C. §§ 1717(b)(2) and 1454 (a)(2). Further, Fannie Mae and Freddie Mac should be required to comply with the conforming loan limit mandated by law (12 U.S.C. §§ 1717(b)(2)(C) and 1454 (a)(2)(C) respectively). The GSEs have not considered the combined LTV of piggyback mortgages when purchasing first or second liens or mortgage-backed securities issued by others that include high-LTV mortgages. Loans structured into first and second liens for sale of one or both components to the GSEs are express structures designed to evade both the credit-enhancement and loan-limit requirements. Simply put, a second lien is not any of the forms of credit enhancement expressly mandated in both of the GSE charters. The banking agencies require a combined LTV approach in setting safety-and-soundness standards. OFHEO can and should do the same, as well as enforce appropriate rules to ensure full and transparent charter compliance.

- OFHEO should institute a formal process to consider safety-and-soundness implications of GSE programs, products and activities. Current law requires only prior approval by the Department of Housing and Urban Development (HUD) of new programs and then only for charter compliance and consistency with the "public interest." HUD is expressly barred by current law (12 U.S.C. § 4541)

from considering safety and soundness because OFHEO in 2001 finalized the GSE risk-based capital rules. However, the prudential and systemic impact of new ventures is a critical supervisory concern. OFHEO should not rely on ongoing examinations to "trip over" ventures, but rather assess them carefully in advance, disapproving or conditioning any new ventures that may pose undue risk.

- The GSEs should make use only of proven forms of credit risk mitigation that are also in strict compliance with their charters (12 U.S.C. §§ 1717(b)(2)(C) and 1454 (a)(2)(C)). Nominal compliance with the charter - for example, through short-term recourse to an originator - should be prohibited. OFHEO should ensure that GSE internal standards for providers of credit risk mitigation exemplify best practices and are at least as strong as governing OFHEO standards.

I. Loan-to-Value Compliance

As noted, the Fannie Mae and Freddie Mac charters expressly require that the GSEs obtain one of three stipulated forms of credit risk mitigation (CRM) when mortgages with LTVs above 80% are purchased. Congress has also established a conventional conforming loan limit to ensure that the GSEs use their substantial benefits to promote home ownership for low-, moderate- and middle-income borrowers, not for those using jumbo mortgages. Loans structured into first and second liens - "piggyback" mortgages, as they are known - are expressly intended to circumvent both of these requirements. The first lien is nominally kept under the 80% LTV ratio and, thus, CRM is not applied. Similarly, for some piggyback loans, the first lien is nominally below the loan limit even though the borrower is in fact

taking out a total mortgage well above the applicable limit.

Bank regulators rightly define mortgages based on their combined LTV, not those of separate portions of loans that may be broken into component pieces precisely to avoid supervisory and capital standards that would clearly apply to a whole loan. For example, the banking agencies determine regulatory capital for second liens based on combined LTV.[1] Similarly, as recently clarified by the agencies' second-lien guidance, the 100%-of-capital limit on high-LTV mortgages is based on a loan's combined LTV in cases where no valid CRM is present, regardless of whether a portion of the loan has been sold.[2]

The bank regulators have also recognized the importance of initial LTV and combined LTV as risk factors for determining risk-based capital under the pending revisions to the risk-based capital rules. A Federal Reserve Board study of mortgage insurance industry data confirmed a direct link between LTV and risk on residential mortgage loans with both frequency of default and severity of loss increasing significantly for high LTV loans. [3] Reflecting the importance of these findings, the U.S. pushed hard for an LTV focus in the advanced internal-ratings-based approach to credit risk under Basel II. The new Basel IA advance notice of proposed rulemaking[4] also adopts LTV as the prime risk driver for determining risk-based capital. All of these agency standards are based on combined LTV to ensure appropriate prudential standards.

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[1] *12 C.F.R. Parts 3, 208, 325, and 567.*

[2] *Credit Risk Management Guidance for Home Equity Lending, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, May 16, 2005.*

[3] *The findings of the FRB study for default and loss rates on 90% and 95% LTV mortgages can be found on p.23 of: The Asset Correlation Parameter in Basel II for Mortgages on Single Family Residences, Paul S. Calem and James R. Follain, Board of Governors of the Federal Reserve System, October 15, 2003.*

[4] *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, October 6, 2005.*

The banking agency prudential standards noted above are essential because insured depositories may hold mortgages regardless of LTV. OFHEO may have thought it unnecessary to impose comparable prudential requirements because of the charter prohibition on purchases of high-LTV mortgages without appropriate credit risk mitigation. However, the GSEs have of late become major purchasers of first liens that are part of piggyback mortgages constructed solely to evade the charter requirement. The GSEs also hold MBS comprised of second liens from high-LTV mortgages and, MICA believes, some whole home-equity loans derived from structured mortgages as well.

Specifically, OFHEO should stipulate by rule that Fannie Mae and Freddie Mac may not purchase a first or second lien related to a home purchase or mortgage refinancing if the initial combined LTV of the two loans on the same residential property is 80% or higher. Current GSE underwriting criteria require originators to disclose the combined LTV of piggyback first liens, with pricing adjusted accordingly. Thus, Fannie Mae and Freddie Mac have full and complete information on which to ensure compliance with such a rule. Any representations that underwriting does not capture such information would reveal a serious safety-and-soundness problem, given the direct correlation between combined LTV and mortgage credit risk.

Similarly, the GSEs can or should know if second liens are provided contemporaneously with a first lien at the time of purchase or refinance. In such cases, combined LTV data are readily available and the GSEs should be required not only to ensure they know this critical fact, but also that second liens that comprise the first loss tranches of piggyback mortgages are not purchased. Mortgage-backed securities (MBS) comprised of the second lien portion of piggyback mortgages should similarly be barred regardless of whatever guarantee may be placed on such MBS because their purchase is

a clear violation of the express legal barrier to GSE purchase of high-LTV mortgages lacking approved credit risk mitigation. Stratagems to circumvent this requirement should be flatly barred by binding OFHEO regulation enforced with meaningful sanctions.

The mortgage industry in general and the GSEs in particular have long noted the direct correlation between initial LTV and the frequency and severity of credit risk. Fannie Mae, for example, concurs with the link between LTV and credit risk, last year noting that "The likelihood of default and the gross severity of a loss in the event of default are typically lower as the LTV decreases, all other factors held equal."[5]

A loan with a CLTV over 80% performs both in terms of frequency of default and severity of default like a single lien with an initial LTV of over 80%. Thus, a piggyback 80/20 loan performs akin to a single lien with 100% initial LTV. The fact that a GSE is holding only the first lien with a putative 80% LTV does not change the fact that the borrower's initial equity in the loan was only equivalent to that of, in this example, a 100% initial LTV single lien. The same holds true for 80/10 and 80/15 piggyback liens. The risk to the GSE of these piggyback loans is the same risk as associated with uninsured single liens of 90%, 95% or 100% initial LTVs. MICA has done extensive research on this which we would be pleased to share with you as needed.[6]

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[5] p.98, Fannie Mae 2003 10-K, March 15, 2004.
[6] For example, MICA noted in a November 3, 2003 comment letter to bank regulators on "Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord," the following: "Controlling for FICO score, original term to maturity, and age of the loan, MICA found that second-lien performance varied significantly based on combined loan to value. Second lien loans with CLTVs between 81% and 90% performed 26.7% worse than second liens with CLTVs of 80% or less. As CLTV went higher the relative performance worsened exponentially...Using MICA's net salvage distribution data...as a means of estimating LGDs [loss given default] between first and second liens with various CLTVs, we find that LGD does vary significantly with CLTV." pp.14-15.

II. Safety-and-Soundness Review of New Ventures

OFHEO has rightly stipulated that prudential regulation of GSE new programs is within its purview.[7] However, without advance notice of new ventures, OFHEO must rely on examiner discovery of problems - potentially putting the GSEs at undue credit, interest-rate, legal, reputational and other risks. Advance notice of new activities ensures that all ventures are brought to the attention of the regulator and that any necessary safeguards are in place before a program begins. This is, of course, why the banking agencies require either a notice and application process or detail exactly which types of business or activities are permissible.[8]

Currently, there is no comparable advance process in which Fannie Mae and Freddie Mac activities receive needed prior scrutiny. As noted, the HUD process does not expressly include a safety-and-soundness review and, in any case, HUD prior review has been honored by the GSEs more in the breach than in actual practice.

Congress is clearly deeply concerned with the risk of new GSE ventures, with pending legislation stipulating advance notice and strict criteria for any new GSE programs, products or activities. MICA strongly supports this legislation which we believe will simply mandate a clear and appropriate process. Nothing in current law limits OFHEO's power now to receive prior notice from the GSEs for all new activities. Indeed, it is our understanding that OFHEO already does receive prior notice of new activities in order to review their treatment under the risk-based capital rule. This is appropriate, but far from complete. New ventures raise many risks that cannot be

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[7] *OFHEO notes in its 2003-2008 strategic plan that the agency "continually evaluates the risks associated with new programs and activities of the Enterprises, conducts additional analysis and tests to address risks that may not be reflected in the stress test, and applies capital measurement tools and techniques to capture alternative perspectives of risk." FY2003-2008 Strategic Plan, Office of Federal Housing Enterprise Oversight, September 30, 2003.*

[8] *12 U.S.C. § 1843 and 12 C.F.R. Parts 5, 7, 225, 362, and 584.*

addressed solely through regulatory capital. For example, a GSE venture may be outside the Enterprise's charter, posing potentially significant legal and reputational risk.

OFHEO should by rule expand upon the current capital-related prior notice for new activities to:

- define activity broadly so that OFHEO receives prior notice in ample time to review all of the prudential implications of a new GSE venture;

- analyze all such ventures from a complete safety-and-soundness perspective, including a review of appropriate regulatory capital. If current GSE minimum capital ratios are not sufficient, then the GSEs' risk-based capital ratios should be adjusted to reflect not only the risk-based capital requirement, but also the appropriate amount of minimum capital. To ensure a full understanding of all prudential risks related to a new venture, OFHEO should ensure it receives timely public comment on each proposed activity; and

- ensure that all new ventures commence only after OFHEO has had full opportunity to review safety-and-soundness issues and, if necessary, impose appropriate restrictions. OFHEO should make all such determinations public to ensure competitive equity between the two GSEs and appropriate market discipline should potential risks emerge as the GSEs engage in these activities.

III. Appropriate Credit Risk Mitigation

As noted, the GSEs' charters require use of one of three forms of CRM when LTVs exceed 80% at the time a GSE purchases a mortgage. It is, as discussed, essential that OFHEO ensure that this charter requirement is met by barring GSE purchase of mortgages or MBS structured so that the LTV criteria are evaded. However, this is not sufficient to ensure charter compliance and prudential operation, as the GSEs could - and indeed have - technically met their CRM charter requirement by reliance on a form of credit enhancement that nominally meets the charter requirement but that, in fact, does not provide meaningful credit risk mitigation over time or in sufficient amount to ensure real protection.

As you know, the charters require the GSEs to rely on one of the following forms of CRM:

- qualified insurance (i.e., mortgage insurance);
- a lender participation (that is, a lender share of at least 10% in the mortgage); or
- complete lender recourse.

MICA recommends that OFHEO by regulation clarify each of these three forms of CRM to ensure that the GSEs rely only on proven forms of CRM and that all structures are robust and not simply designed to evade applicable charter LTV requirements or OFHEO prudential regulation. Key criteria for this regulation should be the proven reliability of the credit risk counterparty to meet future claims, the length of time for which the coverage is in place (which should match times when defaults are most likely, not be just nominal initial coverage), and the depth of the coverage (which should provide protection for expected and unexpected losses given default).

A. Qualified Insurance

OFHEO should stipulate by rule that this term means only loan insurance provided by state-regulated mortgage insurers that enjoy a rating of AA or better from at least one nationally-recognized statistical ratings organization as that term is defined by the Securities and Exchange Commission.[9] Only primary insurance from such providers should be used to satisfy the charter requirement, although OFHEO should clarify that the GSEs may use other forms of qualified insurance or CRM to mitigate additional risk. In such cases, however, OFHEO should stipulate that additional CRM must be obtained from regulated, highly-rated proven providers.

MICA is aware that at least one Enterprise has flirted with credit derivatives and is considering doing so again. Freddie Mac in the past structured the "MODERNS" transaction that laid off credit risk in a complex derivatives structure, and it has indicated interest in again using credit derivatives.[10]

We are aware of no credit derivatives that provide protection analogous to that from primary mortgage insurance. Further, current credit derivatives for corporate loans and bonds have an array of problems that have led regulators such as the Federal Reserve to stipulate a variety of substantial improvements. International regulators have recently issued sound practices for all forms of credit risk transfer (CRT), which include significant safeguards for non-traditional CRT provided by non-regulated entities.[11] A blue-ribbon private-sector panel, the Counterparty Risk Management Policy Group, has not only echoed these concerns, but also expanded on them to propose a variety of self-regulatory

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[9] *17 CFR 240.15c3-1*

[10] *Remarks by Chairman and Chief Executive Officer Richard Syron, Freddie Mac Annual Stockholders Meeting, November 4, 2004.*

[11] *Credit Risk Transfer, Basel Committee on Bank Supervision, Joint Forum, March 2005.*

and federal-agency actions.[12] Of particular concern are major flaws in the infrastructure underlying credit derivatives. These may, regulators and the private-sector panel believe, pose systemic risk.

Given Fannie and Freddie's huge size and their possible market impact, they should not be allowed to use credit derivatives until all of these infrastructure problems are resolved to OFHEO's satisfaction with regard not only to existing types of credit derivatives, but also to the new forms that would be required to hedge mortgage risk. Such mortgage credit derivatives should be offered in the market by private-sector parties and have a demonstrable record over time of reliably absorbing mortgage credit risk before OFHEO permits the GSEs to make use of them. Even then, OFHEO should permit use of credit derivatives only following a public notice and comment that ensures the GSEs engage in credit derivatives with proven counterparties in a fashion that avoids concentration risk and other potential problems.

B. Participations

Retention by a lender of a second lien on a high LTV property is clearly not equivalent to full participation in the loan as required by the GSE charters. Participations are rarely used because of the stiff and appropriate regulatory capital requirements imposed by banking agencies on such arrangements. However, MICA recommends that OFHEO address participations in the needed CRM rule. Such clarification should ensure that loan participations are for the life of the loan, not for a short period of time that may not extend into the period well after mortgage origination when credit risk typically occurs. Short-term participations are a structure designed to evade the charter requirement and they should be expressly prohibited

[12] *Toward Greater Financial Stability: A Private Sector Perspective, Counter Party Risk Management Group II, July 27, 2005.*

C. Recourse

OFHEO should similarly ensure that recourse arrangements cover the entire loan amount and hold for the life of the mortgage. Partial recourse arrangements and arrangements for short periods of time should not be acceptable. We are aware of recent agreements between the GSEs and mortgage originators in which recourse exists only for six months - well ahead of the period three to seven years after origination when loans reach their peak claims period.

OFHEO should also ensure that recourse arrangements are true and binding legal commitments in which the originator continues to bear credit risk and is bound to honor all valid GSE claims. The banking agencies have long required banks to address the legal and operational risk in their commitments for credit risk mitigation. For example, the new Basel standards addressing counterparty credit risk mitigation include a range of requirements before instruments may qualify for capital relief.[13] The CRT paper cited above has similar criteria. These include:

- a legal opinion for each recourse structure to ensure prompt and certain payment;
- due diligence for all providers to ensure they are financially able to bear all claims; and
- contract terms and conditions that terminate such arrangements upon the occurrence of events that may undermine the counterparty's ability to honor a recourse commitment. This can and should include initial posting of high-quality collateral to ensure a claim is honored.

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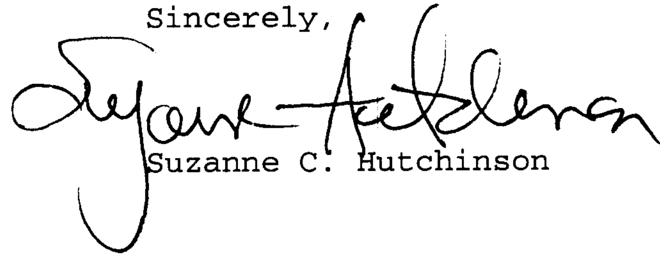
[13] *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, Bank for International Settlement, Basel Committee, June 2004.*

MICA recommends that OFHEO model its CRM rules on the standards noted above to ensure that recourse arrangements truly protect a GSE from credit risk on high-LTV mortgages and, thus, are in full compliance with the GSEs' charters.

Sincerely,



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