Mortgage Insurance Companies of America

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Federal Housing Finance Agency
Office of Strategic Initiatives
400 7th Street, S.W.
Washington, DC 20024

RE: Building a New Infrastructure for the Secondary Mortgage Market, Release for Industry Comment

Dear Sir or Madam:

The Mortgage Insurance Companies of America ("MICA") is pleased to comment on the request for views by the Federal Housing Finance Agency ("FHFA") on ways to enhance the infrastructure used to securitize residential mortgages into the secondary market.[1] MICA is the trade association for the private mortgage insurance ("MI") industry and thus has a keen interest and long experience in the manner in which mortgages are originated and, then, securitized through residential mortgage-backed securities ("RMBS") issued by Fannie Mae and Freddie Mac. We are deeply committed to an efficient securitization infrastructure that promotes not just improved issuance through the government-sponsored enterprises ("GSEs"), but also through Ginnie Mae and the private-securitization market, as contemplated in the infrastructure improvements outlined by the FHFA. However, we urge the agency to move with great caution with regard to facilitating complex risk-sharing in any of these securitization channels and, most importantly in the near term, with regard to any changes made in the manner in which the GSEs structure RMBS. As discussed in more detail below, we believe reliance on structured forms of RMBS risk-sharing, as opposed to use of a regulated and capitalized provider of credit-risk mitigation ("CRM"), poses numerous risks that warrant careful study and robust controls prior to any agreement by FHFA that Fannie Mae or Freddie Mac may make use of any such structures.

MICA recognizes that the general thrust of FHFA's request for views focuses on the manner in which mortgages are structured and serviced in the secondary market, issues which need not involve any change in the manner in which the GSEs or other parties currently

[1] FHFA, *Building a New Infrastructure for the Secondary Mortgage Market* (Oct. 4, 2012), *available at* http://www.fhfa.gov/webfiles/24572/FHFASecuritizationWhitePaper100412FINAL.pdf.

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share the credit risk associated with mortgages at either the loan or MBS pool level. However, the notice states that, "An additional goal of the platform is to facilitate sharing of credit risk much more widely than currently common, so that the conservatorship has less risk and private sector more."[2] This goal is consistent with FHFA's current strategic plan[3] and scorecard[4] for the GSEs, which references this goal in two ways: risk-sharing is contemplated through securitization structures in which the GSEs would subordinate risk to private entities or take a subordinate position themselves and/or through increased use of private MI. MICA urges FHFA in the near term to focus on the use of MI because, in sharp contrast to potential securitized RMBS with complex risk-sharing structures, MI has to date demonstrated its capacity to reduce the conservatorship's risk. To date, the private MI industry has paid out $30 billion in cash and has an additional $3 billion in receivables that stand ahead of taxpayer risk. This $33 billion has come at considerable cost to the private MI industry and its shareholders, but it demonstrates the ability of the industry to pay claims under even catastrophic-risk conditions. In sharp contrast, the vast majority of structured private-label MBS deals have led to significant losses to investors, including Fannie Mae and Freddie Mac. These losses have resulted often from the fact that structuring assumptions – e.g., default rates, prepayment speeds – were incorrect, meaning that reserves generated from "excess spread" or other CRM structures failed. An additional source of default and loss in private-label RMBS comes from the fact that many originators engaged in negligent or even fraudulent practice and then went bankrupt before investors could attempt to enforce representations and warranties.

As demonstrated in the analysis provided below, MICA urges FHFA to defer any risk-sharing based on structured securitizations, instead meeting the vital goal of reduced conservatorship risk through enhanced reliance on private mortgage insurance. As discussed in detail below, we urge this because:

- The U.S. Congress, federal banking agencies, the Securities and Exchange Commission and global regulators are building a reformed regulatory framework for asset securitization designed to ensure that counterparties in structured asset-backed securities ("ABS") can indeed honor their claims and that investors understand the full risk they take in these complex structures. FHFA should not

[2] *Id.* at page 15.
[3] FHFA, *Strategic Plan for Fiscal Years 2013-2017* (Oct. 9, 2012), *available at* http://www.fhfa.gov/webfiles/24576/FinalFHFAStrategicPlan10912F.pdf.
[4] FHFA, *2012 Conservatorship Scorecard* (Mar. 9, 2012), *available at* http://www.fhfa.gov/webfiles/23438/ExecComp3912F.pdf.

authorize, even on a pilot basis, any structured RMBS in which the GSEs participate unless or until this full body of reforms is in place and demonstrably robust.

- Even after completion of this general body of rule for ABS, FHFA must ensure that all of its rules for the GSEs and structured RMBS reflect these standards and, where necessary, enhance them to protect the conservatorship and the broader residential mortgage market. Reducing conservatorship risk through risk-sharing with private entities can be accomplished far more quickly and safely through deeper coverage provided by private MI, as this is a CRM structure FHFA and the GSEs well understand that is backed by private capital validated both through state insurance regulation and ongoing eligibility determinations by the GSEs.

I. Structured RMBS Pose Material Prudential and Market-Integrity Risk

Several provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[5] are intended to address these private-label securitization failings. For example, Section 941 of the law requires risk retention by issuers or originators to ensure better incentive alignment that protects investors. Section 942 mandates an array of new disclosures under the aegis of the Securities and Exchange Commission ("SEC") to ensure investors have all the tools needed to ensure a complete, advance understanding of the risks they bear in private-label ABS and the extent to which representations and warranties are likely to be honored.

Global and U.S. regulators are also seeking to rebuild critical aspects of the securitization infrastructure. Importantly, the Financial Stability Board ("FSB") has recently issued a series of new consultative papers and statements on "shadow banking"[6] making clear that securitization is among the financial activities that may permit the transformation of regulated credit risk into structures outside appropriate banking, securities and insurance standards leading to systemic risk. In addition, the International Organization of Securities Commissions ("IOSCO") has only recently finalized new standards seeking to govern risk-retention practices so that they meet the Dodd-

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[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), §§ 901-991.

[6] FSB, *Initial Integrated Set of Recommendations to Strengthen Oversight and Regulation of Shadow Banking* (Nov. 18, 2012), *available at* http://www.financialstabilityboard.org/press/pr_121118.pdf.

Frank Act's incentive-alignment goal.[7] The head of the Basel Committee on Banking Supervision ("Basel Committee") has also recently reiterated plans now under way to rewrite the capital treatment of asset securitization,[8] new rules aimed in part at ensuring that the real risks created by structured securitizations are appropriately capitalized. Banking agencies are also seeking to address other profound flaws in private-label securitization that so dramatically contributed to the financial crisis, for example by proposing significant new changes to the capital treatment of off-balance sheet obligations such as CRM commitments related to RMBS.[9] The pending rewrite to U.S. capital rules also includes a significant change in the way capital would be required for structured securitizations,[10] rules that might alleviate structuring risk but also a clear indication that the U.S. banking agencies think current capital requirements insufficient in this arena.

FHFA should not, MICA believes, contemplate risk-sharing until the full body of these vital prudential and market-integrity rules is complete and tested. Failing to do so could, MICA believes, expose the conservatorship to significant risk, including "fat-tail" catastrophic risk, because risk-sharing structures could well prove little more than shells when the GSEs seek to obtain credit-risk protection from structured RMBS counterparties. MICA understands that the GSEs could structure RMBS so that third-party investors, not the GSEs, are at risk in the event of a counterparty failure. However, we expect investors will then lodge claims with the GSEs and the conservatorship to make up any losses, doing so in anticipation that the GSEs' guarantee would protect them despite any intervening party to an RMBS structure.

II. FHFA Should Await These Rules and Then Craft Its Own Prudential Framework for Structured RMBS Involving the Conservatorship

As briefly described above, significant investor-protection and prudential standards are under development by a panoply of global and U.S. regulators. MICA urges FHFA to work with them to ensure that

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[7] IOSCO, *Global Developments in Securitization Regulation* (Nov. 16, 2012), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf.

[8] ***Chairman of the Basel Committee Stefan Ingves,*** **Current focus of the Basel Committee: Raising the bar *(Nov. 15, 2012)*, available at *http://www.bis.org/speeches/sp121115.htm*.**

[9] OCC, FRB, FDIC, *Proposed Rule on Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule*, 77 Fed. Reg. 52978 (Aug. 30, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16761.pdf.

[10] OCC, FRB, FDIC, *Proposed Rule on Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52888 (Aug. 30, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-17010.pdf.

its expertise related to RMBS informs all of these rules and makes them ready for rapid deployment in the secondary-market if the new standards prove robust. Even then, however, FHFA will need to address numerous issues specific to the GSEs and their conservatorship before complex RMBS risk-sharing can advance. These issues include:

- **Transparency**: MICA urges FHFA to ensure that any RMBS risk-shares not only comply fully with applicable U.S. and global transparency requirements, but go beyond them to ensure that even relatively unsophisticated investors understand potential risk in these transactions. Because of the unique agency status of the GSEs, investors and/or their intermediaries (i.e., money-market and other mutual funds) may assume that agency-related RMBS have a complete GSE guarantee and, thus, the federal government's "effective" one even though risk is in fact shared with other parties. In the event a GSE counterparty fails to honor its commitment in a GSE structured RMBS, investors could be shocked, creating both risk to them and the broader financial market. Such a market shock could also seriously affect GSE liquidity and issuance capacity until investors better understand the difference between traditional GSE RMBS and the newer, structured instruments.

- **Credit Risk to the GSEs**: As noted, many counterparties in structured RMBS may lack capital to honor their commitments. If the GSE is subordinate to these counterparties in a structured RMBS, then it will take on additional credit risk, likely in a period of market stress at which its own limited capital resources are strained. As FHFA knows well, Fannie and Freddie are required under the revised preferred-stock purchase agreement with the U.S. Treasury[11] to pay all of their earnings into the Treasury, preventing accumulation of retained earnings that would provide a prudential cushion against loss if structured-RMBS counterparties default. To prevent this risk, FHFA should issue rules to stipulate the capital and other prudential criteria required for eligibility as a GSE counterparty in any RMBS risk-sharing transactions.

- **GSE Capital**: In conservatorship, Fannie Mae and Freddie Mac have not been required to meet their regulatory-capital requirements. However, this is not to say that the GSEs can

[11] U.S. Treasury Department, *Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement* (Aug. 17, 2012), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx.

be considered robust in the absence of them. At the least, the GSEs should undertake full-scope economic-capital allocation exercises to assess the capital they should have on hand to absorb structured-securitization risk, doing so without undue reliance on ratings to reflect the requirement in the Dodd-Frank Act[12] that regulatory-capital standards eschew ratings from the nationally-recognized statistical rating organizations ("NRSROs"). This would permit meaningful, forward-looking risk judgments that would insulate the conservatorship and create a more robust framework for additional risk-sharing as the broader infrastructure for mortgage securitization is built out by FHFA and the GSEs.

Conclusion

MICA strongly supports FHFA's goals of building out a new RMBS infrastructure and sharing credit risk with private entities. We urge that FHFA focus now on risk-sharing with private mortgage-insurance companies, not experiment with potentially high-risk complex structures for which a full body of rule is at best incomplete. As made clear by the $33 billion dedicated to date by private mortgage insurers, MICA members have demonstrated their capacity to share risk with the GSEs, honor their claims and protect the taxpayer. Our membership has the capital capacity now to take on additional credit risk in concert with the GSEs, risk-sharing that would immediately reduce risk to the conservatorship without posing an array of prudential and policy concerns.

We would be pleased to provide additional information on the points above or assist the agency in any other regard in this important endeavor.

Sincerely,

Suzanne C. Hutchinson

[12] Dodd-Frank Act, § 939A.