Mortgage Insurance Companies of America

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July 29, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File Number: S7-08-10

Dear Ms. Murphy:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the proposal by the Securities and Exchange Commission (SEC) to reform the risk-retention, disclosure and related requirements affecting asset-backed securities (ABS) [75 FR 23327]. MICA strongly endorses the SEC's goal of encouraging sound lending and incentive alignment for ABS, especially with regard to residential mortgages. MICA represents the interests of the U.S. private mortgage insurance (MI) industry and thus has long advocated for significant improvements in residential-mortgage finance. Indeed, we began to alert U.S. banking agencies as early as 2002 to the need to prevent practices that have now, sadly, put millions of borrowers in foreclosure and contributed to the global financial crisis.

Our fears and calls for improved ABS regulation were included in the MICA comment in 2004 on the SEC's initial draft of Rule AB [70 FR 1506], in which we urged the Commission to address growing problems in private-label securities (PLS) in the mortgage sector. While Rule AB enhanced transparency in the ABS sector and was of considerable value as PLS markets grew rapidly during the "boom" years of private-label mortgage securitization, we continue to feel that the abuses in high loan-to-value (LTV) mortgage lending and other serious underwriting flaws would have been sharply reduced had MICA's recommendations in 2004 been reflected in the SEC's subsequent rulemaking.

But, because mortgage markets now are profoundly fragile, great care needs to be exercised as reforms are finally instituted. We thus strongly support provisions in the Dodd-Frank Act (P.L. 111-203) that take a measured approach to residential mortgage-backed securities (RMBS). As you know, Section 15G(e)(4) of the Securities Exchange Act of 1934[1] as amended by Section 941(b) of the Dodd-Frank Act to

[1] *See* 15 U.S.C. § 78a et seq.

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include an express exemption from risk-retention requirements for "qualified residential mortgages." This new framework will govern the SEC's final rule on risk retention of these loans. As a result, MICA's comments will address the new statutory framework governing the Securities and Exchange Commission to recommend specific provisions that we believe should be reflected in the rule the SEC is charged with developing in concert with other regulators within 270 days of enactment. To support these comments (summarized below), we also provide an update on the condition of the U.S. mortgage insurance industry, which will demonstrate the strong capital that supports MI and the stringent prudential standards imposed on mortgage insurance by state regulation. It is for these reasons that MIs have not only continued to pay claims throughout the mortgage crisis, but now also have significant capital on hand to support recovery in this vital sector.

As you know, the Dodd-Frank Act not only stipulates new risk-retention rules, but also provides the SEC with greater statutory direction and power related to the loan-level and related RMBS disclosures included in the pending proposal. We shall below address those disclosures specifically germane to mortgage insurance, but we would like to note at the outset to this letter our concern that the numerous disclosures proposed for RMBS – 137 at issuance and 151 ongoing ones – are so burdensome that they could stifle market recovery and run counter to the transparency at which the proposal rightly aims. In remarks as recently as July 9,[2] Chairman Schapiro noted, "One of the fundamental requirements for rational investing and efficient capital formation is the availability of high quality information." Great care needs to be taken with regard to revising Rule AB to accomplish this goal.

Before providing detail on these points, our key recommendations for the final revisions to Rule AB are:

- The SEC should ensure that the standards for qualified residential mortgages (QRMs) exempt from risk retention accomplish the stipulated statutory goal of reducing the likelihood of default. The Dodd-Frank Act directs the SEC, along with the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) to recognize the value of MI and other factors that historical loan performance data

[2] Chairman Mary L. Schapiro, remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals (July 9, 2010), available at http://www.sec.gov/news/speech/2010/spch070910mls.htm.

indicate result in a lower risk of default. This occurs for MI because it is capital at risk that promotes incentive alignment and also provides a second underwriting by reviewing credit and collateral risks related to individual loans.

- The regulatory framework that should govern mortgages that do not meet QRM standards should be tempered, as such loans may still be wholly appropriate and sustainable for certain market segments if prudently underwritten. A way to ensure that this occurs is to permit regulated, capitalized first-loss credit-risk protection to exempt a mortgage from risk retention. The SEC should, however, tighten the final version of the rules here to prevent hedging through trading instruments which might have occurred in the framework initially proposed.

- MICA generally supports the proposed loan-level disclosures, although we urge the SEC to review them and omit those that may be duplicative or confusing. We agree, however, that disclosure at issuance on the existence and nature of MI is appropriate given the importance of proven forms of MI to investors. We recommend deletion of the proposed disclosure after issuance related to MI claim denial and rescission, as this information is not generally gathered and is of minimal value to investors.

I. Condition of the U.S. Mortgage Insurance Industry

As a broad preamble to MICA's comment, we would like first to update the SEC on the condition of the U.S. private mortgage insurance industry. Current data reinforce the points we discuss and support the recommended treatment of MI in the SEC's framework for RMBS. MI insurance-in-force at April 30, 2010 was $829 billion, or 8.6 percent of U.S. single-family first liens then outstanding.[3] Giving effect to the strong risk to capital requirements imposed by state insurance regulators, the industry has capacity to insure an additional $261 billion in insurance in force in each of 2010, 2011, and 2012. This translates to approximately 1.3 million additional mortgages in each of those years – an important contribution to housing recovery, especially for low- and moderate-income first-time homebuyers who may lack large

[3] MICA, *Monthly Statistical Report*, April 30, 2010, *available at*: http://www.privatemi.com/news/statistics/detail.cfv?id=163. Fannie Mae, *Economics and Mortgage Market Analysis: Housing Forecast: May 2010*, *available at*: http://www.fanniemae.com/media/pdf/economics/2010/Housing_Forecast_051210.pdf.

downpayments but still have ample capacity to enjoy sustainable home ownership. These first-time homebuyers are crucial to the reduction in excess housing inventory which is essential to a full recovery in the housing market.

The first loss position of private mortgage insurance makes it a valuable offset to mortgage credit risk. This benefit extends to lenders that hold loans in portfolio, investors in securitizations collateralized by loans with MI, and, in the case of Fannie Mae and Freddie Mac, to taxpayers who are otherwise exposed to government-sponsored enterprise (GSE) losses. Over the course of the current mortgage crisis, the MI industry estimates that it will pay around $30 billion in claims in front of the taxpayer to Fannie Mae and Freddie Mac. Indeed, since the current mortgage crisis began, Fannie Mae and Freddie Mac have received from MIs $14.5 billion in claim payments and receivables, equivalent to 10% of the amount U.S. taxpayers have had to spend to date on these GSEs during their conservatorship.

Importantly, the MI industry has ample regulatory capital, with MIs distinguished among all sources of private capital in U.S. residential-mortgage finance due to recent capital inflows to the industry based on investor confidence in the business model and its regulatory construct. An additional $7.4 billion in capital has been raised by existing MIs and investors have provided a further $575 million for a new entrant to the industry since the mortgage crisis began.

MIs have also played an active role in preventing otherwise-avoidable foreclosures, thus advancing the public policy goals of sustainable mortgage lending and appropriate loan modification. Over 199,000 trials have been started by MIs under the HAMP,[4] with 34,945 completed through the first quarter of 2010. Further, the industry has participated in 53,901 approvals under the HARP,[5] with 41,155 closed refinances during this same time period. These efforts combined with other MI-related loan workouts resulted in 374,304 completed workouts from 2008 through the first quarter of 2010 by the MI industry, covering $73.8 billion in mortgage loans.

Due to the factors noted above, the recent report from the Joint Forum of global banking, securities and insurance regulators endorsed

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[4] Department of the Treasury, *Making Home Affordable Summary of Guidelines*, March 4, 2009.
[5] Ibid.

mortgage insurance as an important element of a reformed mortgage origination and securitization framework.[6]

II. QRMs Should be Defined to Reflect the Role of Private Mortgage Insurance in Reducing the Risk of Default

We have provided all the data above and the description of MI structure to ensure that the Commission has a complete and current understanding of the proven value of MI in reducing the risk of mortgage default. As noted, Congress has directed a complete exclusion of qualified residential mortgages from otherwise-mandatory risk retention, thus answering the question raised by the SEC in its proposal as to whether any such exemption should be provided. Now, as mandated by the Dodd-Frank Act, the Commission must instead turn to the rules it is required to issue within 270 days of enactment jointly with the FRB, OCC and FDIC. MICA's comments thus address our views as to how this law should be implemented.

Although Section 941 gives regulators factors to consider in determining QRMs exempted from risk retention, it does not stipulate any final rule. MICA believes that qualified residential mortgages for this purpose should include underwriting and product features such as: documentation and verification of a borrower's financial resources, standards regarding a borrower's ability to repay the loan (based on a borrower's income and the ratio of income to housing and other debt obligations), factors that mitigate the potential for "payment shock," and a requirement for mortgage insurance at the time of origination.

The requirement for mortgage insurance is an important feature of a qualified residential mortgage. Private MIs are required by regulation to place their own capital at risk on every loan they insure – mortgage insurers have "skin in the game" on every loan they insure, and thus a clear economic incentive to ensure that their loans are prudently underwritten. But, because MIs do not insure a lender against 100

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[6] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation Key Issues and Recommendations*, January 2010, at p. 17. "*Other factors important to an effective underwriting program:* The following are not substitutes for sound underwriting practices but should be taken into consideration when determining the soundness of an underwriting program. Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements), and should take steps to require adequate mortgage insurance in instances of high LTV lending (*e. g.*, greater than 80 percent LTV)."

percent of losses (typically MI insures against the first 20 - 25 percent of losses), lenders are still accountable for careful underwriting standards, and have a clear financial incentive to ensure that their loans comply with those standards.

A study of over 20 million mortgage loans made between 2002 and 2008 found that mortgages with the characteristics noted above for qualified mortgages performed almost three times better than loans that had one or more risk characteristics (as measured by foreclosure or 90-day delinquency rates). Qualified mortgages performed better regardless of when the loan was originated, and regardless of where the home was located. The data confirm that qualified mortgages are significantly lower risk than loans that are not prudently underwritten.[7]

MICA also urges that no "piggyback" mortgages should be allowed to qualify as QRMs. Piggyback mortgages (those with simultaneous second liens) were a major factor in the run-up to the current crisis, with many originated to evade requirements in the charters of Fannie Mae and Freddie Mac[8] that limit the maximum loan amount that the GSEs may purchase and require MI or another form of credit enhancement for mortgages with LTVs above eighty percent. In effect, MI functions like the margin requirements used in the equity-securities context to prevent excessive leverage. Instead, "80/10/10s", "85/15/5s", and "80/20s" (denoting the percentage amount of the first and second mortgages and borrower down payment respectively) proliferated because applicable bank capital rules did not recognize the true risk inherent in the retention or securitization of second liens.

In addition to our extensive comments before the SEC on Rule AB, MICA repeatedly urged bank regulators to recognize the true risk of piggyback mortgages as the crisis worsened, noting the risk they posed to borrowers, Fannie Mae and Freddie Mac, and banking organizations.[9] The agencies finally took action on home equity loans and lines of credit

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[7] *Historical Performance of Qualified vs. Non-Qualified Mortgage Loans*, February 2010, *available at* http://www.restorethedream.com/assets/documents/QM%20vs%20Non-QM%20Loan%20Analysis.pdf.

[8] *See* 12 U.S.C. § 1717 and 12 U.S.C. § 1454 respectively for Fannie Mae and Freddie Mac.

[9] *See for example*, MICA's letter of December 3, 2002 to U.S. bank regulators regarding the appropriate treatment of structured mortgages under the recourse rule focusing on the higher risks associated with structured second liens and the need for adequate capital requirements. See also letter dated September 23, 2005 from MICA to Hon. Susan Bies, Hon. John Dugan, Hon. Donald Powell and the Hon. John M. Reich.

in 2005[10], but the guidance at that time was implemented inconsistently. As the SEC knows all too well, these loans are a serious financial-market risk and an impediment to mortgage-loan modifications that prevent otherwise-avoidable foreclosures. Moreover, a recent study prepared by Genworth Financial, based on performance data compiled by First American Corelogic, demonstrated that the performance of 80 LTV first liens originated with a simultaneous second lien was on average nearly 60% worse than insured loans of comparable CLTV, FICO score and origination year.[11] Piggyback loans are both dangerous to the borrower and the lender and unnecessary. Thus, MICA recommends that underwriting standards adopted for purposes of QRM exemption prohibit any residential mortgage transaction involving a piggyback second lien.

Further, MICA recommends mandatory credit risk mitigation on all loans with CLTVs above 80% that is provided by well capitalized and regulated credit enhancers. The underwriting standards for high CLTV loans should reflect the risk management value of the credit enhancement used as a partial replacement for the cash down payment by the borrower provided the credit enhancer is MI or another form of regulated and well capitalized credit enhancement, or insurance from the Federal Housing Administration (FHA) or a similar government agency. These loan-level forms of credit risk mitigation place capital at risk and with respect to MIs provide a second underwriting and other controls that protect investors and borrowers.

Indeed, failure to recognize the role of credit enhancement would threaten the mortgage market recovery. Overly restrictive down payment requirements resulting from the failure to recognize well capitalized credit enhancement would undermine the fragile market recovery as first-time, low- and moderate-income home buyers seeking to take advantage of lower home prices would see their purchase opportunity at best delayed if not foregone as a consequence of unnecessarily high minimum down payment requirements. When private or federal capital, relying on its own prudent underwriting criteria, is put at risk on these mortgages, it ensures appropriate borrower and investor protection.

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[10] *Credit Risk Management Guidance for Home Equity Lending* (May 24, 2005), Financial Institution Letter (FIL-45-2005) (FDIC), OCC Bulletin 2005-22 (OCC), SR letter 05-11 (FRB), CEO Letter 222 (OTS), *available at* http://www.fdic.gov/news/news/press/2005/pr4405a.html.

[11] *Insured Versus Piggyback Loan Analysis, available at http://www.restorethedream.com/assets/documents/Insured-vs-Piggyback-Loan-Analysis.pdf.*

III. Non-QRM Risk-Retention rules Should Reflect the Value of Capitalized Credit Risk Mitigation

In the SEC's proposal, many questions are asked regarding the value of a QRM exception that have now been generally resolved by the Dodd-Frank Act in favor of the framework on which MICA has commented in the above discussion. However, the SEC specifically asked several questions related to its own rules that remain potential issues for the new, broader framework for mortgage securitization on which MICA is pleased also to comment. It is vital that the SEC work with the other regulators not only on the QRM eligibility criteria for the risk-retention exemption, but also on the broad ABS framework that will govern other mortgage securitization which, while perhaps not appropriate for wholesale exemption from risk retention, is still an appropriate channel for providing liquidity to the U.S. residential-mortgage market. Appropriate calibration of the overall ABS requirement for these RMBS will promote healthy markets even if not all loans are QRMs.

With regard to mortgages not eligible for QRM exemption from risk retention, the SEC should join with other regulators and use the authority granted in section 941 to exempt securitization structures where first-loss coverage is provided by regulated, capitalized providers of credit risk mitigation. In the proposal, the SEC suggests that such an exemption be granted from risk retention if some first-loss coverage is obtained, and MICA supports this if the first-loss risk is borne by an entity that has claims-paying capacity comparable to the demonstrable one for mortgage insurance described at the beginning of this comment letter.

The SEC's proposal, like the broad framework for ABS in the Dodd-Frank Act, states that credit risk could not be directly hedged. However, the proposal makes clear that holdings of index-related positions that short a credit-risk position are allowed, although they do not affect "net" calculations. This could create strong incentives for sponsors to use trading instruments to short credit risk, undermining the value of risk retention where it is required. While not directly applicable to QRMs, MICA nevertheless urges the FDIC to review its broad framework related to hedging and bar any evasion of this statutory prohibition except in cases where credit risk mitigation is provided through capitalized insurance or other risk-mitigation structures over substantial periods of time, not available only as short-term trading instruments that could quickly be dispensed with.

The proposal also solicits views on whether risk hedging could be permitted but only if accompanied by a higher risk-retention requirement (e.g., at least ten percent). This approach of course may not be applicable to QRMs pursuant to the complete exemption for such loans from risk-retention as provided in the Dodd-Frank Act. However, MICA urges the SEC also not to apply it with regard to other loans, including mortgages. If credit risk is hedged through use of first-loss, capitalized and regulated mitigation such as MI, it is absorbed with capital at risk that, as discussed above, fully meets the SEC's and Congressional goals of incentive alignment. Use of third-party risk mitigation provides additional capital to promote credit availability without any of the perverse incentives resulting from undisciplined securitization through the "originate-to-distribute" model. The data presented above, especially with regard to the sharply higher default rates associated with high-LTV loans that lack MI, demonstrate clearly the value of capitalized credit-risk hedging such as that provided by MI and the SEC should thus encourage this, not impose additional, punitive risk-retention requirements.

IV. Disclosures

Finally, MICA respectfully comments on the SEC's proposed disclosure regime for RMBS. In general, as noted, we urge the Commission to simplify its disclosures to the greatest degree possible to minimize the possibility that complex, lengthy disclosures will so confuse investors that they turn again to rating agencies or others who make credit-risk and investment-goal decisions in ways that, while simple, can all too often pose conflicts of interest or otherwise lead to the types of lax due diligence that helped to precipitate the current crisis. Many provisions in pending Commission rules and the Dodd-Frank Act address this risk, and MICA has repeatedly commented on various SEC proposals to press for an end to rating-agency reliance in a wide array of rules and disclosure requirements. However, even upon enactment of the new law and further action by the SEC, investors will still turn to others if the disclosures presented to them are overwhelming and complex – a serious risk given the breadth and depth of loan-level and related disclosures proposed by the SEC in this release.

With these general comments in mind, MICA would like now to turn to the proposed disclosures that specifically address private mortgage insurance. Four of the proposed initial disclosures directly reference mortgage insurance. RMBS issuers would be required to disclose:

- whether mortgage insurance is required;
- the name of the mortgage insurance company, coverage plan type, certificate number, and insurance coverage percentage;
- whether the insurance is lender or borrower paid; and
- if there is pool insurance, the name of the pool insurance provider and pool insurance stop loss percentage.

If a mortgage insurance claim has been submitted to the primary mortgage insurance company for reimbursement, the following four data points also would have to be disclosed in ongoing RMBS disclosures:

- the date the claim was filed and the date it was paid;
- the amount claimed and the amount paid;
- the date the claim was denied or rescinded; and
- if the property were conveyed to the insurance company, the date of conveyance.

In general, MICA supports all of the proposed initial disclosures related to the presence of private mortgage insurance and its composition. Because private MI has the demonstrated value to investors discussed throughout this comment letter, we believe it vital that investors know whether or not it is present and the salient facts related to it. We recommend, however, that the SEC clarify this requirement to stipulate that "mortgage insurance" means "private mortgage insurance" as defined by section 2 of the Homeowners Protection Act of 1998.[12] This is also the language defining private mortgage insurance in the section of the tax code that permits mortgage insurance to be tax deductible.[13] Reliance by the SEC on this definition would thus ensure a common framework for recognizing MI in federal standards and bar representations that unregulated mortgage-risk protection is "mortgage insurance" that provides the protection anticipated by the SEC in the proposed disclosures.

MICA does, however, urge the SEC not to require ongoing disclosure of MI claims denial and rescission. These loan-level data are not now included in investor remittance reports and the process of gathering it could prove complex and burdensome, especially given the possibility that loans within an RMBS may have multiple providers of

[12] *See* 12 U.S.C. § 4901(13).
[13] *See* 26 U.S.C. § 163(h)(4)(E).

private mortgage insurance. Mortgage insurers do not deny claims or rescind coverage absent strong indication of fraud or other serious failures by the originator to comply with all policy requirements. The thrust of all of the other disclosures recommended by the SEC will ensure that investors have ample data on which to determine originator internal controls, loan quality, underwriting criteria and ongoing performance. As a result, the additional data point related to MI claims and rescissions will create a significant operational burden for servicers without any resulting improvement in investor analytics related to loan quality.

Conclusion

MICA is grateful for the leadership demonstrated by the Securities and Exchange Commission in its initial proposal to revise Rule AB. Providing this proposal so early in the deliberations that must now begin to implement the Dodd-Frank Act ensures a careful rulemaking process that does not “rush to judgment” despite the very short turn-around for critical ABS rules mandated in the Dodd-Frank Act. We urge the SEC to build on the direction provided by Congress for defining QRMs to reflect the proven value of private mortgage insurance and otherwise to craft risk-retention and disclosure rules that ensure that the ample capital available in private mortgage insurance can be deployed in a prudent fashion to promote a rapid recovery of the U.S. residential-mortgage market.

We would be pleased to provide any additional analysis or data of use to the Commission as you advance all of the new rules now required to reform mortgage securitization.

Sincerely,

Suzanne C. Hutchinson