ESSENT
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Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090
File No. S7-14-11

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219
Docket Number OCC-2010-0002

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. R-1411

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
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Regulations Division
Office of General Counsel
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Washington DC 20410-0500

Re: Credit Risk Retention Proposed Rule

Ladies and Gentlemen:

Essent Guaranty, Inc. ("Essent") submits this letter in response to the request for comments made by the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Board"), Federal Deposit Insurance Corporation ("FDIC"), U.S. Securities and Exchange Commission ("Commission"), Federal Housing Finance Agency ("FHFA"), and the Department of Housing and Urban Development ("HUD") (collectively, the "Agencies") on the proposed rules to implement the credit risk retention requirements of Section 15G of the Securities and Exchange Act of 1934 (the "Proposed Rules") in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

Essent is a privately held company, formed in 2008 to assume residential mortgage credit risk. Essent is licensed to transact mortgage guaranty insurance ("MI") in all fifty of the United States and the District of Columbia, and is approved by the government sponsored housing enterprises, Fannie Mae and Freddie Mac (the "GSEs"), to provide insurance on the mortgage loans they buy or guarantee. Essent is actively writing MI nationwide, working to fulfill our mission to support safe and affordable homeownership for borrowers by insuring lenders and mortgage investors from credit losses. Essent has the capital capacity to serve a growing market need for MI.

MI is an insurance contract that pays benefits to residential mortgage lenders or investors if a mortgage defaults. While MI is a flexible, proven product that can be tailored to meet the credit risk-bearing needs of mortgage lenders and investors, MI is most commonly utilized to provide a first-loss credit enhancement (e.g., the first 25% of loss) on a loan that defaults and goes to claim.

MI companies are private enterprises that serve as independent, third-party, long-term retainers of credit risk within the U.S. housing finance system. As such, MI companies have developed specialized risk management capabilities in the areas of mortgage credit underwriting, due diligence, quality control, risk sizing, pricing, and life-of-loan risk management conducted in partnership with the lenders and investors our product insures.

The private capital of MI companies has served to protect mortgage investors, including taxpayers, from substantial credit losses arising from the financial crisis. Albeit financially challenged by the housing crisis, MI companies have continued to serve the markets and pay claims without a taxpayer bailout. In fact, estimates suggest that MI companies will pay $40-60 billion in claims from private capital and the largest single beneficiary of MI claim payments will be the U.S. taxpayers (insofar as most MI claims are paid to Fannie Mae and Freddie Mac). In addition, when the housing market crisis became apparent, MI companies acted to tighten credit guidelines, preventing loans with a high risk of default under distressed market conditions from being made. These private market risk disciplines mitigated losses that would otherwise have occurred at the GSEs and protected less capable borrowers from being financed into homes in markets at risk of sharply declining home prices. The systemic credit loss mitigation provided by the MI industry is an example of a strong, countercyclical regulatory capital framework for bearing risk provided by a competitive private industry.

Actions such as the adoption of Essent's proposal, summarized below, can play an important role in reaffirming the value of MI and thereby help attract additional capital into the MI industry, if necessary, to meet increased demand as private securitization markets return to play a larger role in U.S. housing finance.

We provide an Executive Summary of our proposal, followed by a Detailed Proposal and Discussion of the proposal's merits, including proposed text for the final rule.

EXECUTIVE SUMMARY

Essent proposes that MI should be recognized by the final rule as providing a permitted means to satisfy the Risk Retention[1] requirement applicable to securitized residential mortgage loans by giving RMBS sponsors credit towards satisfaction of the Risk Retention requirements for loans insured with MI. Essent's detailed proposal specifies the type and amount of MI recommended for satisfaction of the Risk Retention requirements.

[1] Terms utilized in the upper case in this Executive Summary are defined in the Detailed Proposal and Discussion section.

Essent's Proposal Is Beneficial and Meets the Intent of the Dodd-Frank Act

Essent's proposal helps ensure high quality underwriting standards and risk management practices for the securitizers and originators of assets that are securitized or available for securitization. MI companies are third-party, arms-length and long-term retainers of the first-loss credit risk on residential mortgage loans. With their capital at risk in the event of claims caused by defaults, the economic incentives of MI companies are closely aligned with those of security investors in ensuring sound underwriting and risk management. These incentives are made even stronger by the fact that Essent's proposal requires loan-level MI coverage of 2X the Risk Retention requirements of the sponsor, creating a larger exposure to loss for the MI company than under a sponsor's "vertical slice" Risk Retention requirement.

MI companies help ensure high quality underwriting standards through a number of practices including establishment of underwriting guidelines for their insurance programs, underwriting loans themselves in some instances, conducting quality control reviews on new business and monitoring the manufacturing practices and loan quality of lenders with whom they do business. MI companies have strong incentives to conduct these activities because they retain a substantial portion of the credit risk on the loans they insure.

MI companies also enhance the risk management of the loans they insure once those loans are securitized, by conducting on-going surveillance activities with regard to the performance of loans within a RMBS and by reviewing problematic loans and claims. Such diligence by the MI company supports all the investors in a security. MI companies also have strong incentives to work constructively with borrowers and servicers to approve reasonable modifications of distressed loans or other alternatives to foreclosure, because MI claims are triggered by a transfer of title to the property securing a loan (either through foreclosure or approved sales to third parties). If home retention for the borrower is not possible, MI company interests are aligned with orderly liquidation of the loan on a timely basis.

In sum, Essent's proposal fully meets the investor protection objectives of the Risk Retention requirements of the Dodd-Frank Act. Essent's proposal is analogous to the treatment under the Proposed Rules for CMBS, where the retained interest by the sponsor is not required if a third party purchaser of subordinated tranches, i.e., a "B-Piece Buyer," meets certain conditions. The beneficial risk-bearing and market conduct practices of CMBS B-Piece Buyers are similarly fulfilled by MI companies.

Essent's proposal will improve the access of consumers to mortgage credit on reasonable terms by increasing the access of small and large lenders to securitization. The permitted use of MI to satisfy sponsor Risk Retention requirements enables expanded access and market capacity for securitization by providing an additional source of capital with which to access securitization markets. This preserves the long-standing ability in U.S. residential housing finance for smaller lenders, and those without very large capital bases, to access the liquidity and risk transferability of securitization markets and compete to serve borrowers cost-effectively without having to be large holders of Risk Retention positions in the form of mortgage assets which require the management of complex, long-term mortgage risks. MI can expand access to capital for securitization while maintaining the incentives for sound underwriting and risk management for the loans included in an RMBS.

Essent's proposal is in the public interest by advancing the policy objective of expanding the use of private capital to bear credit risk relative to government-backed mortgage programs. Allowing private insurance to fulfill sponsor Risk Retention requirements will remove what would otherwise be an inherent economic advantage to sponsors from the utilization of government mortgage insurance programs (primarily FHA and VA), or GSE-guaranteed securitization programs, both of which do not require sponsor Risk Retention in the Proposed Rules. Essent's proposal will also encourage loans originated for sale to the GSEs (with MI) to be sold into private markets, should private markets become more liquid and competitively priced to GSE execution. In the absence of Essent's proposal, private securitization will have to offer a better all-in execution versus GSE securitization in order to make the costs and burdens of the Risk Retention requirement on the sponsor worthwhile for MI-insured loans that can be sold in either market.

Essent's proposal is further in the public interest because it enhances the stability of the U.S. housing finance system. The Proposed Rules require that Risk Retention be fulfilled in "funded" form, primarily through sponsor retention of a portion of the underlying mortgage assets or RMBS. Absent adoption of Essent's proposal, the U.S housing finance system for private RMBS will come to be dependent on essentially one method of fulfilling Risk Retention requirements – sponsor-retention of mortgage asset or RMBS exposure. There are systemic risks arising from creating a system reliant on only one basic form of Risk Retention. Essent's proposal will help create a more stable housing finance system than one built solely on sponsor-retained funded Risk Retention because the use of MI as proposed has four major beneficial systemic impacts: (A) reduces liquidity risk; (B) creates a pool of countercyclical capital for credit risk in the system; (C) increases risk bearing resilience within the system; and, (D) results in better risk management. These benefits are derived from the foundational elements of the MI capital structure and business model, arising from prudential regulatory requirements imposed on the MI industry from the lessons learned in prior housing crises. In the detailed discussion of the benefits of Essent's proposal, we present the specific reasons why expanding the forms of Risk Retention to include MI provides beneficial impacts to the housing finance system.

Essent's proposal preserves long-standing precedent of MI fulfilling Congressionally-mandated risk retention requirements still in use in the market today. Congress has a long-established precedent with regards to risk retention in the single-family residential mortgage market, reflected in the charters of the GSEs. In chartering the GSEs, Congress established risk retention requirements on sellers of mortgage loans to the GSEs for mortgages with LTVs in excess of eighty percent. Such sellers are required to either: (1) retain risk through a repurchase obligation for defaulted loans; (2) retain a 10% participation in the loans (i.e., a 10% "vertical slice"); or, (3) insure the portion of the UPB of the loan above 80% with coverage from a qualified MI company. In the context of the GSE charters, sellers of loans to the GSEs are the functional equivalent of securitization sponsors in the Dodd-Frank Act and Proposed Rules. Congress wisely saw fit to allow the insurance of low-down payment loans as a valid risk retention alternative in the GSE Charters because of the credit loss protection inherent in the insurance product (e.g., reduced severity of loss and enhanced risk management), and the alignment of interests that private insurance companies have with quality underwriting and sound risk management. The use of MI to meet GSE charter-based risk retention requirements has been particularly valuable to smaller and mid-sized lenders which originate high quality loans but do not have the capital resources to act as a long-term holder of mortgage credit risk or mortgage assets on their own balance sheet. The risk retention requirement imposed on sellers of loans to the GSEs – and fulfilled by MI - ultimately saved the GSEs (and thus the taxpayers) billions of dollars of losses during the recent housing crisis.

DETAILED PROPOSAL AND DISCUSSION

I. Essent's Proposal: Treat MI Coverage Meeting the Terms and Conditions Contained in This Proposal as an Allowable Risk Retention Option for RMBS Sponsors.

The Dodd-Frank Act authorizes the Agencies to jointly develop regulations for securitizers to retain an economic interest in a portion of the credit risk for residential mortgage assets (the "Risk Retention") that the securitizer sells or transfers through issuance of an asset-backed security (the "RMBS"). Essent proposes that MI should be recognized by the final rule as providing a permitted means to satisfy the Risk Retention requirement applicable to residential mortgage loans that are securitized.[2] This proposal contemplates two structures under which MI would be given credit towards risk retention requirements, a "Loan-Level" MI policy and a "Horizontal Slice" MI policy.

A. How Essent's Loan-Level Insurance Proposal Would Work

Utilizing the Loan-Level MI policy, the sponsor's total Risk Retention requirement would be reduced by a pro-rated amount based on the unpaid principal balance ("UPB") of the insured loans in the security that have MI coverage equal to at least two times the sponsor's overall Risk Retention requirement. MI coverage of twice (2X) the required Risk Retention percentage ensures a strong economic alignment of interest between MI companies and RMBS investors and provides an added prudential measure of coverage. The Agencies may also find it appropriate to increase the 2X factor to some higher amount, such as 3X, should the final rules establish a risk retention requirement of less than 5% for some loans. For example, should a class of loans be identified where the appropriate Risk Retention percentage is 2.0%, a Loan-Level MI coverage of 6.0% (3X the Risk Retention) might be more appropriate.

We demonstrate the operation of the Loan-Level proposal through three examples below, each assuming a $500 million RMBS and a Risk Retention requirement of 5%, or $25 million.

1. *Example #1* - All loans in the RMBS are insured with at least 10% MI coverage (2 times the 5% Risk Retention requirement). In this case, the sponsor's Risk Retention requirement would be reduced to zero, having been fully satisfied by the MI insuring all of the UPB of the loans in the RMBS.

2. *Example #2* - All loans in the RMBS have 5% MI coverage. In this case, the Risk Retention requirement of the sponsor is the full 5% or $25 million, because no loan has MI coverage of 10% or greater.

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[2] Our proposal addresses Question 19(a) of the Proposed Rules: "Are there other forms of risk retention that the Agencies should permit?," and Question 19(b): "If so, please provide a detailed description of the form(s), how such form(s) could be implemented, and whether such form(s) would be appropriate for all, or just certain, assets."

3. *Example #3* - $250 million of loans have 10% MI coverage, $50 million have 20% MI coverage and the rest have no MI coverage. In this case, $15 million of the Risk Retention requirement would be satisfied by MI and the remaining $10 million of Risk Retention (or 2% of the securitization on a net basis) would be the responsibility of the securitization sponsor. The MI credit is calculated based on a 5% credit on the $300 million in UPB of loans with at least 10% MI coverage. We propose that the sponsor's net Risk Retention requirement which is not fulfilled by MI coverage be satisfied through any of the other allowable methods in the Proposed Rules.

B. How Essent's "Horizontal Slice" Insurance Proposal Would Work

In addition to Loan-Level MI, MI can be transacted on a portfolio of loans subject to an aggregate limit on the claims to be paid pursuant to the policy (generally referred to as a "stop loss" limit), commonly a fixed dollar amount calculated as a percentage of the original outstanding balance of the mortgage loans in the portfolio (the "Horizontal Slice MI" policy). For example, such a Horizontal Slice MI policy on a $500 million RMBS with a 5% stop-loss limit would absorb losses from defaulted loans subject to the terms of the Horizontal Slice MI policy until such losses totaled 5% of the original balance of the RMBS (i.e., $25 million). In this manner, the operation of the Horizontal Slice MI policy is similar to the operation of a 5% "horizontal slice" Risk Retention by the Sponsor, and analogous to the treatment of B-Piece interests in the CMBS context (discussed further in Section II(A), below).

Given their similarities, our proposal contemplates that a Horizontal Slice MI policy would reduce the Risk Retention requirements of a sponsor choosing to meet the Risk Retention requirement through retention of a horizontal slice. The sponsor's portion of the Risk Retention would be reduced by the amount of the horizontal slice insured by the MI policy. For example, if the horizontal slice Risk Retention required in the final rule was 5%, the sponsor's Risk Retention requirement would be reduced by the amount that the required Risk Retention loss exposure is absorbed by the Horizontal Slice MI policy. If the insurance policy covers 3% of the loss, the sponsor would be responsible for holding a horizontal slice for the remaining 2% of uninsured exposure. If the Horizontal Slice MI policy were of a size sufficient to meet the sponsor's entire required horizontal slice Risk Retention percentage, the sponsor's Risk Retention requirement would be satisfied in whole by the Horizontal Slice MI policy.

II. <u>Essent's Proposal Is Beneficial and Meets the Intent of the Dodd-Frank Act</u>

This proposal has many societal benefits and is consistent with the applicable standards for satisfying the Risk Retention requirements of the Dodd-Frank Act.

A. Essent's proposal helps ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization.

An independent MI company, as a long-term holder of mortgage credit risk with capital at risk when a loan defaults, has incentives at least as powerful in ensuring sound underwriting and risk management as those of the sponsor retaining risk. Unlike the sponsor, the MI company does not make a gain on the sale of the security and therefore is not motivated to inflate or otherwise obscure the real value and risks of the security.[3] MI companies set underwriting standards as a requirement for insuring loans, underwrite many loans themselves, and conduct due diligence on the loan originator's practices. These practices serve to establish prudent and sustainable lending requirements for low-down payment loans that can be securitized in today's market. Moreover, MI companies pay claims on loans that fail and so are directly motivated to set appropriate underwriting standards and to perform due diligence on the loans, the loan originators, and the securitization sponsors. MI companies routinely reject loans for insurance when they do not meet their underwriting guidelines or eligibility requirements. These sound underwriting and risk management practices are precisely the kinds of actions that the Dodd-Frank Act and the Proposed Rules seek to see diligently implemented on behalf of security investors.

These incentives are made even stronger by the fact that this proposal requires loan-level MI coverage of 2X the Risk Retention requirements of the sponsor, strengthening the alignment of interests by creating a larger exposure to loss for the MI company than under the security sponsor Risk Retention requirement. For example, in a pool that experiences 10% defaults, each with a 25% severity of loss, an MI company writing the minimum 10% loan level coverage required in this proposal has a contractual claim exposure of approximately[4] 1% (10% default rate x 10% coverage). By contrast, a 5% vertical slice Risk Retention piece would lose .125% (10% default rate x 25% severity of loss x 5% Risk Retention). The MI coverage, as loan-level insurance of twice the Risk Retention requirement, will incur greater losses than a 5% vertical slice exposure across most reasonable loss scenarios, creating a very strong alignment of interests with security investors in sound underwriting and risk management practices.

Essent's proposal is analogous to the treatment under the Proposed Rules for commercial mortgage backed securities ("CMBS"), where the retained interest by the sponsor is not required if a third-party purchaser of subordinated tranches (the "B-Piece Buyer") meets certain conditions. The Proposed Rules note that the allocation of a first-loss position to a B-piece Buyer has been common practice in CMBS transactions for a number of years. The Proposed Rules state that in order to manage its risk, the B-piece Buyer often is involved early in the securitization process and has significant influence over the selection of pool assets. For example, the B-piece Buyer often performs due diligence on the pool assets and may request that specific loans be removed from the pool prior to securitization. To be eligible to satisfy the Risk Retention requirement, the B-piece Buyer must specifically negotiate for the purchase, hold adequate resources to back losses, provide due diligence

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[3] MI premiums are typically collected monthly in arrears, but annual and single premium plans are also offered; in the event that MI premiums are paid in advance, the MI company establishes an unearned premium reserve and amortizes that premium into income over time. MI companies do not record a profit or gain on the inception of a policy.

[4] MI paid claims generally exceed 100% of the amount of the insurance coverage because they include uncollected interest, property preservation costs, foreclosure and other costs. Typically when a claim is paid, it is for 110-115% of the stated amount of the MI coverage.

on the assets in the pool and meet the same standards for Risk Retention as those in the Proposed Rules.

The beneficial risk-bearing and market conduct practices of CMBS B-Piece Buyers are similarly met by MI. While Essent believes that sound risk management for insuring loans in an RMBS does not necessitate that the MI company underwrite each and every loan, the Agencies may wish to consider such a requirement.

The interests of MI companies are aligned with the interests of the investors in a securitization in sound underwriting and risk management. The alignment of interests between MI companies and RMBS investors under Essent's proposal is stronger than the alignment of interests created by security sponsors retaining a 5% vertical slice risk exposure. In addition, as MI companies take credit risk only, the MI provider has a greater alignment of interest with RMBS investors in sound underwriting and risk management than does a B-Piece Buyer, who is also motivated by the interest rate cash flows associated with the B-Piece. To the extent that the Agencies have established Proposed Rules to effectuate the Dodd-Frank Act's allowance for a B-Piece Buyer to satisfy a Risk Retention requirement in the CMBS context, the Agencies should be equally supportive of Essent's proposal.

B. Essent's proposal encourages appropriate risk management practices by the securitizers and originators of mortgage loans, improves the access of consumers to mortgage credit on reasonable terms, and is otherwise in the public interest and for the protection of investors.

1. <u>Essent's proposal not only encourages sound underwriting, but also supports sound risk management and servicing practices during the life of the coverage.</u>

   MI company incentives to support sound risk management practices are not limited to the origination of the mortgage loan. As a long-term first-loss credit risk bearer with claims triggered by transfer of title to the property securing a loan (either through foreclosure or approved sales to third parties), an MI company has strong incentives to engage in and support risk management activities through the life of the insurance coverage, including sound servicing practices. MI risk management practices can vary among participants but we note below some of the most commonly utilized.

   MI companies engage in on-going surveillance activities with regard to the performance of loans within a RMBS once the security is issued. MI companies monitor portfolio performance versus expectations and may conduct reviews on loans that experience early payment defaults. When borrowers encounter difficulties with making their mortgage payments, an MI company's economic interests align with constructive engagement with servicers and workout alternatives that can keep borrowers in their homes. MI companies often assist loan servicers in contacting borrowers and benefit by approving economically sensible workouts which can enable successful home retention. If home retention is not possible, MI company interests are aligned with orderly liquidation of the loan on a timely basis. In instances of loans that go to claim, MI companies can enforce representations and warranties when violations are identified. During this crisis, some mortgage investors have utilized the work of MI companies to review loans and identify problems. This diligence by the MI company supports the investors in a security and can help RMBS investors identify problematic loans and take appropriate actions.

In sum, the economic motivations of MI companies align their interests with sound risk management practices through the entire life of the mortgage loan, from origination through the ultimate payment of a claim.

2. Essent's proposal improves consumer access to mortgage credit on reasonable terms by increasing the access of small and large lenders to securitization.

Essent's proposal enhances the functioning of the securitization market by promoting sound underwriting and risk management practices, while also expanding the potential sources of private capital that can be utilized in the securitization process to meet the requirements of Risk Retention. By enhancing the functioning of the securitization market, this proposal improves the access of consumers to mortgage credit on reasonable terms.

The use of MI to satisfy some, or all, of a sponsor's Risk Retention requirement enables expanded access and market capacity for securitization. Smaller lenders who originate high quality mortgage loans that are subject to Risk Retention requirements and wish to securitize those loans may not have the balance sheet capacity or may lack the risk management skills to hold and fund a complex retained mortgage asset with interest rate risk, embedded prepayment option risks, implicit interest rate caps and floors, and credit risk. Even larger sponsors may face limits on their capacity to hold the required retained risk assets due to insufficient capital levels or concentrations of risk exceeding prudential limits, particularly if their mortgage lending programs are large relative to the size of their overall institution. If so constrained, these entities would need to curtail lending activities and raise costs to consumers without the ability to tap alternative sources of capital. It is important to note that the Risk Retention requirements in the Proposed Rules cannot be hedged and do not sunset, so entities holding the retained risk must be very confident in their capital capacity and allocations to mortgage risk over a long period of time. Sponsors with doubts as to their capacity to hold these retained risks for the long-term can be expected to curtail lending.

Satisfaction of the Risk Retention requirements through MI will give sponsors an additional source of capital with which to access securitization markets by using the Risk Retention capacity of the MI at a market price for the risk. This preserves the long-standing ability in U.S. residential housing finance for smaller lenders, and those without very large capital bases, to access the liquidity and risk transferability of securitization markets and compete to serve borrowers cost-effectively, without having to be large holders of Risk Retention positions in the form of mortgage assets which require the management of complex, long-term mortgage risks.

A well-functioning securitization market, expanded by the permitted use of MI to satisfy the sponsor's Risk Retention, will result in lower costs of financing for mortgage borrowers. Products such as the 30-year fixed rate mortgage, which protects families from the challenge of managing interest rate risk, require securitization in order to be broadly available at affordable costs.

3. Essent's proposal is in the public interest by advancing the policy objective of expanding the use of private capital to bear credit risk relative to government-backed mortgage programs.

   The nation's current residential mortgage market is largely nationalized, with government-backed mortgage insurance (primarily FHA and VA) and securitization programs representing a substantial majority of all new mortgage originations. Nearly all new residential mortgage securitization in our country is being done by government-backed programs – either GNMA with regard to loans with FHA and VA guarantees or the GSEs. The Obama Administration and the Congress have strongly expressed a policy objective of an increasing role for private capital to price and bear mortgage credit risk, and a correspondingly smaller role for government. There is a near unanimous public policy consensus towards the need for private capital and private markets to play a larger role and government programs to play a smaller role in mortgage financing going forward. Therefore, allowing private insurance to fulfill sponsor Risk Retention requirements will remove what would otherwise be an inherent economic advantage to sponsors from the utilization of government mortgage insurance programs, or GSE-guaranteed securitization programs, both of which do not require sponsor Risk Retention in the Proposed Rules.

   Essent's proposal will also encourage loans that are originated for sale to the GSEs to be sold into private markets, should those markets become more liquid and comparably priced to GSE execution. The Obama Administration and many in Congress are urging higher GSE guarantee fees in order to encourage loans that might otherwise have been securitized by the GSEs to be securitized in private markets. Historical lender practice for loans eligible for securitization by both the GSEs and private markets is to plan for the loans to be securitized through the GSEs because of the certainty of execution, but to opportunistically sell loans into private securitizations if the overall execution terms are favorable. Most securitization sponsors that sell to the GSEs utilize MI to meet the GSE requirements (see our discussion of the "GSE Charter Precedent," on page 11 below) for low-down payment loans under their federal charters. MI is generally placed on the loans at origination; therefore if these loans are later securitized through private markets, the loan-level MI will already be in place. Giving the sponsor no credit for the MI already obtained, and thus requiring full sponsor Risk Retention, will necessarily disadvantage private securitization. Private securitization would actually have to offer a better all-in execution versus GSE securitization in order to make the costs and burdens of the Risk Retention requirement on the sponsor worthwhile for loans that can be sold in either market.

   The disadvantages faced by private RMBS markets versus GSE securitization is addressed by our proposal to give credit towards the Risk Retention requirement for the use of loan-level MI, thereby promoting the efficiency of capital allocation and sensibly creating a more equitable balance between government-backed and private securitization.

4. Essent's proposal for the use of MI is consistent with long-standing prudential risk retention requirements established by Congress and in use in the market today (the "GSE Charter Precedent").

   Congress has a long-established precedent with regard to risk retention in the single-family residential mortgage market, as is reflected in the charters of the GSEs.[5] The relevant section from Fannie Mae's charter is as follows:

   > *No such purchase of a conventional mortgage secured by a property comprising one- to four-family dwelling units shall be made if the outstanding principal balance of the mortgage at the time of purchase exceeds 80 per centum of the value of the property securing the mortgage, unless*
   >
   > *(A) the seller retains a participation of not less than 10 per centum in the mortgage;*
   >
   > *(B) for such period and under such circumstances as the corporation may require, the seller agrees to repurchase or replace the mortgage upon demand of the corporation in the event that the mortgage is in default; or*
   >
   > *(C) that portion of the unpaid principal balance of the mortgage which is in excess of such 80 per centum is guaranteed or insured by a qualified insurer as determined by the corporation.*

   In the context of the GSE charters, sellers of loans to the GSEs are the functional equivalent of securitization sponsors in the Dodd-Frank Act and Proposed Rules. In chartering Fannie Mae and Freddie Mac, the Congress clearly established "risk retention" requirements on sellers of mortgage loans to the GSEs for mortgages with LTVs in excess of eighty percent. As expressly stated in the charter act requirements above, sellers are required to retain risk themselves through a repurchase obligation for defaulted loans, a 10% participation in the loans (i.e., a 10% "vertical slice"), or the risk retention requirement may be satisfied if the portion of the UPB of the loan above 80% is insured by a qualified MI company. This prudential standard establishes an alignment of interests between private market sellers of mortgage loans and the GSEs as investors in the loans, or guarantors of 100% of the risk for loans sold into GSE securities.

   Congress wisely saw fit to allow the insurance of low-down payment loans as a valid risk retention alternative in the GSE Charters because of the credit loss protection inherent in the insurance product (e.g., reduced severity of loss), and the alignment of interests that private insurance companies have with quality underwriting and sound risk management practices.

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[5] Fannie Mae is chartered under the Federal National Mortgage Association Charter Act, 12 U.S.C. 1716, et seq., and Freddie Mac is chartered under the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1451 et seq.

The use of MI to meet GSE charter-driven risk retention requirements has been particularly valuable to smaller and mid-sized lenders, such as credit unions and community banks, which originate high quality loans but do not have the capital resources to act as a long-term holder of mortgage credit risk or who did not wish to manage the interest rate and prepayment risks inherent in holding such assets on balance sheet.

The risk retention requirement imposed on sellers of loans to the GSEs – and fulfilled by MI - ultimately saved the GSEs (and thus the taxpayers) billions of dollars of losses during the recent housing crisis. The ability of the MI industry to pay these claims from private capital occurred because of the strong, countercyclical capital framework and sound regulation of MI companies, discussed further in this comment letter. Although the GSE charters only require the portion of the loan above 80% to be insured, the GSEs have generally obtained MI for the portion of the loan above (approximately) 67%[6], further reducing the losses suffered by the GSEs during the crisis.

We note that, had the GSEs utilized MI more broadly, in all likelihood the housing finance system would have benefited from the development of a larger base of private capital supporting credit risk. The GSEs suffered substantial losses on loans with LTV ratios at or below 80% that did not have MI coverage. These lower LTV loans (some with second liens extended at the same time as the first lien resulting in a CLTV above 80% without the loan being insured) demonstrated that even loans with lower LTVs can create a substantial risk of loss during periods of economic stress and home price declines. These undercapitalized risks in the system ultimately resulted in large taxpayer losses.

5. <u>Essent's proposal is in the public interest because it enhances the stability of the U.S. housing finance system.</u>

The Proposed Rules require that Risk Retention be fulfilled in "funded" form. Funded Risk Retention positions herein are defined as credit risk bearing positions whereby the sponsor retains a portion of the underlying mortgage assets, which in most cases is expected to be an interest in the RMBS issued. If adopted, Essent's proposal expands the available Risk Retention options by allowing the use of MI as an alternative. Absent adoption of Essent's proposal, the U.S housing finance system for private RMBS will come to be dependent on essentially one method of fulfilling Risk Retention requirements – sponsor-retention of mortgage asset or RMBS exposure. There are systemic risks which may arise from creating a system reliant on only one basic form of risk retention. This letter has already set forth why Essent's proposal protects RMBS investors as well or better than sponsor risk retention and why it creates expanded access to securitization markets for lenders and consumers. In addition, Essent's

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[6] For example, customary GSE MI requirements are 30% coverage for 95% LTV loans and 25% coverage for 90% LTV loans. 30% coverage on a 95% LTV loan results in an effective net LTV of 66.5% (95% less 30% of 95%).

proposal will create a more stable housing finance system than one built solely on sponsor-retained funded Risk Retention because the use of MI as proposed (A) reduces liquidity risk, (B) provides countercyclical capital in the system, (C) increases risk bearing resilience within the system and (D) results in better risk management.

(A) MI Reduces Systemic Liquidity Risk. When a well-capitalized MI company insures a loan, there is real capital standing behind the risk that is identifiable, measurable, safely invested, and trapped and targeted to the payment only of claims. Particularly important is that the claim-paying assets of an MI company are not funded with debt, therefore not subject to margin calls and debt rollovers that can cause a liquidity crisis in times of financial stress. In contrast, a funded Risk Retention position is likely to be partially, if not substantially, financed with borrowings. The use of borrowings to finance funded Risk Retention positions will expose the system to substantial liquidity risk during times of financial stress and concern with the value of mortgage assets. This fact was made readily apparent during the recent crisis, when many holders of tranches of private RMBS found themselves facing declining asset values and margin calls or difficulty rolling over or accessing needed sources of funding. Liquidity panics create pro-cyclical systemic responses to stress, as holders of mortgage assets sell into already weakened markets. As the Proposed Rules do not allow Risk Retention positions to be sold (or credit-hedged), entities under financial duress holding such exposures will find themselves with limited financial flexibility to take risk-limiting actions. Therefore, allowing a portion of the Risk Retention capital pool to come from the stable capital base of mortgage insurers provides a more stable and reliable credit risk-bearing system.

(B) MI Creates Countercyclical Capital In the System. The capital structure of the MI industry operates in a countercyclical fashion, building up reserves in periods of favorable economic conditions which create claims-paying capacity in times of economic stress. The creation of this countercyclical capital arises from the requirement that MI companies fund contingency reserves with 50% of earned premiums and hold such reserves for 10 years, to be released only in years in which the MI's loss ratio[7] exceeds 35%. This regulatory requirement appropriately tailors capital to the cyclical, long-lived and long-tailed nature of mortgage credit risk. The use of MI to fulfill a portion of the Risk Retention requirement creates in the system a pool of inherently countercyclical capital that stabilizes the system, as opposed to pro-cyclical capital which increases systemic risk. To the extent that reserves for the credit risk in funded Risk Retention positions are held in accordance with GAAP, the pro-cyclical nature of GAAP loan loss reserves is widely recognized as a problem in the crisis and an on-going issue.

(C) MI Increases Risk-Bearing Resilience In the System. MI increases risk bearing resilience in the system by increasing diversification of credit risk and creating a fully cross-collateralized pool of capital to retain credit risk.

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[7] Loss ratio in any given year is defined as the ratio of incurred losses over earned premiums.

(1) Greater Diversification. MI business is conducted nationwide with numerous lenders, serving a range of mortgage loan product and borrower risk characteristics. The business model results in a reasonably diversified pool of mortgage risk across geographies, lenders, mortgage products and borrower risk characteristics. In contrast, funded Risk Retention will result in the retained risk being held in numerous small holdings of mortgage assets, often isolated to each RMBS issued. Securitizations are likely to be concentrated by originator, mortgage loan type, borrower risk characteristics and possibly geography by the normal operation of the origination and securitization markets. In addition, the need to securitize assets quickly to reduce market risk in the aggregation process results in the issuance of RMBS with a relatively small number of loans. Mortgage credit performance can vary widely across small pools of mortgage loans even with seemingly very similar characteristics. These factors inherently result in less diversified credit risk exposures to the sponsors who hold the funded Risk Retention pieces.

(2) Cross-collateralization. MI is fully cross-collateralized because the entire pool of MI capital is available to support a claim from any segment of the insurance portfolio. As a result, MI should result in more effective loss absorbing capacity within the housing finance system. Funded Risk Retention positions are not cross-collateralized. This means that over-funded credit support from well-performing pools does not absorb any of the losses from under-funded credit support in poorly performing pools. MI is therefore a more stable and resilient form of credit risk-bearing within the system.

(D) MI Results in Better Risk Management Within the System**.** The mortgage crisis demonstrated some of the very serious limitations created by the risk management complexities and inflexibilities of RMBS structures as opposed to the flexibility of risk management by entities. These problems became most apparent in mortgage loan servicing of private RMBS, where diffused ownership of securities and inflexible transaction documents limited the ability of servicers to minimize losses and respond to the needs of borrowers. In addition, inherent conflicts of interests exist between holders of different tranches of an RMBS. These conflicts inevitably influence how loans are serviced and how borrowers are helped (or not helped) in many instances. In contrast, MI companies have interests more closely aligned to those of security investors and have the flexibility to adapt to changing circumstances and public policy. In an RMBS, neither the trustee nor the holder of 5% of a securitization has the ability to negotiate revised business terms on behalf of all of the holders of the securitization. MI companies, with business managers fully accountable for their insurance coverage, can revisit and renegotiate contract terms and business practices with lenders, servicers and investors to meet changed market and individual circumstances.

Risk Retention through MI also benefits the system through the specialization of credit risk management. Mortgage credit risk is complex and requires specialized skills and capabilities to analyze, price and manage through the entire life-cycle of the mortgage assets. MI companies are mono-line entities that specialize in the management of U.S. mortgage credit risk for the long-term. The specialization and the scale of the MI industry enable the development of expertise in managing credit risk. This specialization creates strong business incentives for MI companies to make the necessary investments in people, systems, processes, data, modeling and other supporting risk management capabilities to properly manage the risk.

Finally, Funded Risk Retention positions may place risks into the hands of entities that need the liquidity of securitization markets but may not be specialized and expert managers of the funded retained risk. Funded Risk Retention positions bear credit risk, interest rate risk, mortgage prepayment risk, embedded interest rate cap and floors risk (i.e., ARM loan rate and payment adjustment limits) and liquidity risk. These risks can be complex and may require extensive risk management expertise, as well as the ability to access funding and interest rate hedging markets. Consequently, entities that are not strong bearers of the entire bundle of risks associated with Funded Risk retention may be required to hold them by regulatory requirement, resulting in suboptimal risk management within the system.

III. Credit Enhancements which Satisfy the Risk Retention Requirements Should Meet Sound Criteria Founded on Prudential Principles.

For a private credit enhancement structure to be given recognition towards Risk Retention requirements as we propose, it should meet strict criteria that create as much, or more, safety and soundness for investors in a securitization as would the proposed sponsor Risk Retention.

Allowable credit enhancement providers under this proposal should meet five key principles, namely: (A) have a strong capital framework; (B) provide the enhancement on an arms-length basis; (C) have sound business practices consistent with sound underwriting and risk management; (D) have clear and reliable terms of coverage; and (E) be properly regulated.

A. Strong Capital Framework. While all five principles are critical, the capital framework is perhaps the most essential element of the criteria. Many have noted that the capital framework of the MI industry, among private and government entities bearing credit risk, was uniquely effective through the mortgage crisis and should serve as a model for the future. The MI industry has a strong, countercyclical capital framework where the assets of the credit enhancement provider are safely invested, and trapped and targeted solely for the payment of residential mortgage losses. State authorizing statutes modeled after the NAIC Mortgage Insurance Model Act require a contingency reserve be established (in addition to other required reserves) and funded with 50% of earned premiums to be held for ten years and released only in years in which the MI's loss ratio exceeds 35%. This framework creates the long-term alignment of economic interests between the RMBS investor's exposure to credit risk and the MI provider's capital-at-risk when loans default and create an MI claim. The MI provider has clear motivation to ensure sound underwriting and risk management practices, or will suffer the consequences by paying claims.

B. Arms-Length Basis. Credit enhancements allowable under this proposal should be done on an arms-length basis between the securitization sponsor and the credit enhancement provider. This is essential to ensuring the integrity of the transaction and the alignment of interests between the credit enhancement provider and the security investors. The MI industry is required to meet prudential standards that ensure appropriate arms-length relationships that would protect security investors. MI companies cannot do business with originators or servicers who have a material (e.g., greater than 10%) ownership interest in an MI company. This and other regulations prohibiting conflicts of interest (e.g., no compensating balances on deposit with the lender, no underwriting of mortgages originated by a member of the same holding company system, no consideration paid as inducement for any MI business) ensures that MI companies have arms-length relationships to mortgage market participants who could place undue influence on the issuance, pricing or claims-paying practices of the MI provider.

C. Sound Business Practices. To ensure sound underwriting and risk management, the credit enhancement provider must have appropriate business practices. MI companies set underwriting standards, conduct counterparty due diligence, in many cases underwrite loans themselves, conduct quality control reviews on insured loans and conduct on-going monitoring of the performance of the loans and pools during their life. In essence, MI companies own the "first loss" on a mortgage loan that ultimately defaults, so the practices of a well-managed MI company would mirror those of a well-managed lender that will hold the credit risk on mortgage loans and therefore align strongly with security investor interests in sound underwriting and risk management practices.

D. Clear and Reliable Terms of Coverage. For treatment as an allowable form of Risk Retention, a credit enhancement must have clear contractual terms with regard to the obligations of the parties, resulting in a highly reliable process for the review of underwriting and fraud and the timely payment of valid claims. Improvements in credit policy and underwriting practices are coinciding with a movement towards increased clarity in the terms and conditions of MI policies to create more alignment and shared expectations about the payment of MI claims. In addition, GSEs have elevated minimum standards for MI policies. Essent has enhanced its master policy coverage terms to more clearly define accountabilities among the parties, remove contractual ambiguities and establish fair and consistent claim practices. These changes provide a contractual commitment to the market on every loan Essent insures, which provides clear and reliable coverage terms that benefit every originator, servicer and policy beneficiary of an Essent insured loan.[8] Essent's master policy enhancements should serve to help restore investor confidence, which in turn can help restore confidence in private RMBS.

[8] See Essent's Mortgage Guaranty Insurance Master Policy and Clarity of Coverage[SM] endorsements, approved by all states, at www.essent.us.

E. **Appropriate Regulatory Oversight**. For treatment as acceptable Risk Retention, credit enhancement providers should be subject to proper regulation. The MI companies are regulated primarily by the various state insurance commissioners. However, in addition, MI companies need approval to do business with the GSEs, and the GSEs (which are under conservatorship by a FHFA, a federal regulator) have comprehensive eligibility standards for qualifying MI companies. GSE standards have the effect of extending an additional layer of national regulatory oversight to the MI industry.

IV. Essent's Proposal is Permissible under the Dodd-Frank Act and is Not Prohibited Hedging Activity

Mortgage guaranty insurance should be an accepted method for sponsors to satisfy their Risk Retention requirements in RMBS transactions, for the many sound economic and public policy reasons presented in this comment letter. The Dodd-Frank Act requires that the final regulation, "prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset."[9] The Dodd-Frank Act does not require that the utilization of MI as proposed by Essent be regarded as a hedge.

In fact, the use of MI as proposed by Essent is fundamentally different from the hedging activities sought to be restricted by the Dodd-Frank Act. The intent of the hedging prohibition is to align the interests of a third-party with the interests of security investors in sound loan underwriting and risk management practices. To permit a security sponsor to sell 95% of the interest in the security and then to hedge the credit risk only on the sponsor's retained exposure clearly circumvents the goals of the Dodd-Frank Act and should not be permitted. In contrast, the use of MI as proposed by Essent protects all of the insured assets in a securitization rather than representing just a transfer of the sponsor's retained risk. As such, MI provides cash flows from claim payments as well as underwriting, due diligence and other risk management practices (conducted by the MI company prior to writing the coverage and during the life of the coverage) to the benefit of all investors in the RMBS. Moreover, the use of MI in RMBS issuances is subject to robust disclosure requirements for the benefit of investors.[10]

To the extent, however, that the Agencies conclude that the use of insurance as specifically proposed by Essent is a prohibited hedging activity, Essent's proposal should be explicitly

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[9] Dodd-Frank Act, Section 941(c)(1)(a).

[10] The existence of MI as external credit enhancement to help ensure that the securitization will pay in accordance with its terms is subject to disclosure under the requirements of Regulation AB, including the material terms of the policy, any conditions that must be met before the policy can be accessed, and the policy is to be filed as an exhibit. Moreover, enhanced financial data is required to be disclosed if the MI is liable or contingently liable for payments representing 10% or more, but less than 20% of the cash flow of any offered class of the security, and financial statements meeting the requirements of Regulation S-X must be included if the MI is liable or contingently liable to provide payments representing 20% or more of such cash flows. Typical loan-level coverage MI policies fall into this last category.

permitted in the final rule, because it meets all of the applicable standards for exemptions, exceptions and adjustments to the rules, which require that a permissible adjustment:

> *(A) Ensures high quality underwriting for securitized assets; and*
> *(B) Encourages appropriate risk management practices, improves the access of consumers to mortgage credit on reasonable terms, and is otherwise in the public interest and for the protection of investors.*[11]

The arguments in Section II of this letter establish that MI is a valid means to satisfy a sponsor's Risk Retention requirements.

V. Essent's Proposed Text for the Final Rule

Essent proposes the following text be added to the proposed rule in the final version:

SUBPART B – CREDIT RISK RETENTION

Insert the following new section after Sections after § __.8:

§ .8A Mortgage Guaranty Insurance Risk Retention.

(a) In general. A sponsor satisfies that portion of its risk retention requirements under § __.3_ of this part with respect to a securitization transaction to the extent that either:

(1) A loan in a securitization has loan-level mortgage insurance coverage equivalent to no less than two times the sponsor's risk retention requirement (expressed as percentage of the loan balance); or,

(2) The security has horizontal slice mortgage insurance coverage which insures some or all of the credit risk exposure which satisfies the requirements of §___.5(a), and,

which coverage shall be effective prior to or contemporaneously with the issuance of the security, and with respect to which all of the conditions of subsection (b) are met:

(b) Conditions.

(1) Insurance Company in Good Standing. The mortgage insurance is issued by an entity licensed to transact mortgage guaranty insurance in all jurisdictions in which properties securing loans in the securitization transaction are located. In addition, for so long as Fannie Mae and Freddie Mac are in conservatorship, the mortgage guaranty insurance company is a qualified mortgage guaranty insurer duly approved to insure loans eligible for delivery to Fannie Mae and Freddie Mac;

(2) Insurance for the Benefit of Investors in the Trust. The cash flows from the payment of mortgage insurance claims are for the benefit of the trust and to be paid to security investors in accordance with the cash flow distribution rules of the security. The sponsor shall have no authority to cancel, modify or revise the terms of the insurance coverage after the security has been issued.

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[11] Section 941(e)(2)

(3) *Coverage. The mortgage insurance company shall write the coverage only pursuant to a mortgage guaranty insurance policy approved by each jurisdiction in which the company seeks to insure risks, in accordance with applicable laws and regulations of such jurisdictions.*

(4) *Mortgage Insurance Risk Review. The mortgage insurance company writing the coverage conducts an appropriate review of the risk of the assets insured in the security prior to the issuance of the coverage, which includes at a minimum a review of the underwriting standards, origination practices and collateral.*

(5) *Arms-Length Insurance and Control Rights.*

   i. *The mortgage insurance company is not affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor, originator or servicer) other than investors in the securitization transaction. For purposes of this restriction, affiliation shall mean any ownership interest between the mortgage insurance company and the restricted affiliated parties to the securitization transaction in excess of 10%.*

   ii. *The mortgage insurance company does not have control rights in connection with the securitization transaction (including, but not limited to, acting as servicer for the securitized assets) that are not collectively shared with all other investors in the securitization.*

(6) *Disclosure. The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and it's appropriate Federal banking agency, if any, disclosures regarding the mortgage guaranty insurance in accordance with Regulation AB.*

(c) Hedging, transferring and pledging. Mortgage insurance that qualifies under this section does not violate the restrictions in §__.14 of this part applicable to the originator or sponsor pursuant to this section.

Closing Comments

The Risk Retention requirements were intended to help restore the functioning of a sound private securitization market for residential mortgage loans. Essent's proposal is consistent with restoring a sound private securitization market and an expanded role for private capital in U.S. housing finance. Essent's proposition is simply that MI (or any credit enhancement product meeting the criteria proposed herein) utilized in an appropriate amount and structure be recognized by the final rule as a permitted means for sponsors to satisfy their Risk Retention requirements in the issuance of RMBS. Our letter has summarized how Essent's proposal ensures high quality underwriting for securitized assets and encourages appropriate risk management practices, improves the access of consumers to mortgage credit on reasonable terms, and is otherwise in the public interest and for the protection of investors.

Essent respectfully proposes the language in Section V of this letter be added to the final rule. We submit that our proposal meets the standards that Congress established for the Agencies to define a sponsor's Risk Retention obligation for RMBS and the means by which it may be satisfied.

We appreciate the opportunity to present Essent's views on the Proposed Rules. If you have any questions concerning these comments or would like to discuss these comments further, please contact at your convenience.

Sincerely,

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