8

Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

July 12, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth St. NW
Washington, DC 20549-0609

RECEIVED
JUL 1 2 2004
OFFICE OF THE SECRETARY

Re: File No. S7-21-04

Dear Mr. Katz:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the Securities and Exchange Commission (SEC) proposal to revise the registration and disclosure rules governing asset-backed securities (ABS) published in 69 *Federal Register* 26,650. MICA members provide private mortgage insurance (MI) that is used as credit enhancement on billions of dollars of mortgage underlying mortgage-backed securities (MBS) issued by the government-sponsored enterprises and private issuers. We thus have a strong interest in the liquid, transparent and resilient ABS market this proposal would advance.

MICA appreciates and strongly supports the SEC's goal of increasing investor understanding of the often complex instruments in the ABS market. This is particularly critical in the MBS market. Here, participation by the government-sponsored enterprises (GSEs) creates the impression that the federal government backs MBS issued by Fannie Mae and Freddie Mac. Similarly, investors may think the federal government stands behind other issues (e.g. manufactured housing securities or home equity loan issues) that are credit enhanced by the GSEs. Investors need full and complete information on critical factors on all GSE-issued or -enhanced ABS to ensure a complete understanding of the real risks involved in

1425 K Street, NW
Suite 210
Washington, DC 20005
(202) 682-2683
Fax (202) 842-9252

such securities. Without such information, "moral hazard" is created because investors will rely solely on the implicit government guarantee and acquire ABS without appropriate regard to underlying risk.

In general, MICA believes the array of disclosure standards that codify and expand upon those now used by ABS issuers are timely and appropriate. However, we urge the SEC to clarify the proposal to require disclosure of loan-to-value (LTV) ratios. As discussed in more detail below, LTV is a critical risk component in MBS and thus, investors that lack clear LTV information will not benefit from the overall effort to improve investor understanding of credit risk. First, the LTV presented to them in the ABS registration and follow-up filings may materially misrepresent credit risk because an investor may believe he or she is purchasing an MBS comprised of very low LTV mortgage interests when they are in fact purchasing MBS comprised of the riskiest type of a very high-LTV mortgage structure. Collateral and related disclosures may not make clear that collateral is subordinated to holders of a first lien and disclosures on credit enhancement could well be misunderstood because investors do not fully understand that the assets are high-risk ones that require far more credit enhancement than ordinarily applied to low-LTV MBS.

Recently, "structured mortgages" have become an increasingly significant part of the market. In these, borrowers split their mortgages into first and second liens to avoid otherwise applicable MI requirements. The second lien pieces can then be sold into MBS that appear to be comprised of low LTV assets (e.g., 10% to 15% LTV ratios), even though the combined LTV on the mortgage taken out by the borrower is 90% or higher. As discussed in more detail below, investors must be told the combined LTV of the loans of which their MBS investments are a part so they can accurately assess the collateral and credit enhancement likely to back their investment and related risk factors.

Below, we provide additional information on structured mortgages and the risks they present, noting recent findings from the FDIC and other sources to support this view. Reflecting this, we urge the SEC to clarify that "loan-to-value" disclosures as required on 69 *Federal Register* 26727 means loan-to-value ratio, including the combined loan-to-value ratio resulting from other loans taken out by the same borrower at the same time as the loans included in this ABS.

Structured Mortgages

Structured mortgages are, as discussed in more detail below, a growing part of the national mortgage market. As a result, they are an increasingly significant segment of the MBS market and an issue on which investors need full information to make informed decisions.

Often called 80-10-10s, structured mortgages are those in which a borrower takes out a first and second lien to purchase a house or refinance a mortgage. The charters governing Fannie Mae and Freddie Mac require them to ensure that effective third-party credit enhancement is in place when a mortgage they purchase has an LTV above 80%.[1] MI is the principal form of credit enhancement used to comply with these charter requirements because of its historical reliability and the prudential capital and supervisory regime under which MI firms operate.

Despite the express charter requirement to protect taxpayers on high-LTV mortgages held or guaranteed by the GSEs, Fannie Mae and Freddie Mac have actively promoted structured mortgages. Under them, borrowers take out a first lien with an 80% LTV ratio that is sold by the lender to a GSE. The borrower then takes

[1] 12 U.S.C. 1717(b)(5)(C) and 12 U.S.C. 1454(a)(4)(C).

out a second lien of 10% or even more to avoid having to use a down payment. This results in mortgages with combined LTVs of 90%, 95% or even more than 100%. These second liens are then either held in portfolio by the loan originator or, increasingly, structured in MBS that are sold to investors.

Based on a study by SMR, a major mortgage research firm, 12.59% of all the homes purchased with financing in 2001 used two-loan combination deals. This was up from 11.25% in 2000 and 8.87% in 1999. Thus, the market share of structured mortgages rose 42% in only two years.

Separately, MICA member firms reviewed their own proprietary information as well as information from a secondary market agency to assess the size of the structured loan market. Our results show a market that has grown from $44 billion in 1999 to an estimated $113 billion for 2002.

Investor concerns

Bank regulators have long recognized that two mortgages issued to the same borrower at the same time for the same purchase or refinancing transaction should be treated as the same mortgage when held on the bank's own books. [12 CFR § 567.1] They have done so because of the very substantial risks associated with structured loans.

Earlier this year, the FDIC noted that:

> Although private mortgage insurance (PMI) mitigates the risk of collateral losses to lenders, it does not cover all risks, specifically those from "piggyback" loans. By convention, borrowers are required to supply at least 20 percent down to avoid paying for PMI. But certain loans, typically called 80-10-10 loans, are

> structured to avoid paying for PMI, and thus no insurance is obtained. Under an 80-10-10, a homebuyer with a 10 percent down payment obtains a loan for 80 percent of the home's purchase price at a standard interest rate and then gets a second, or piggyback, loan at 10 percent of the purchase price, but at a higher interest rate. This type of financing adds leverage over the traditional 20 percent down payment loan at the same time it avoids PMI, a safeguard for lenders. While lending programs such as piggybacks, subprime mortgages, and ARMs have allowed greater opportunities for homeownership, they also may present increased credit risks to lenders, particularly should interest rates rise or home prices fall.[2]

Private mortgage insurance companies have been collecting performance data on high LTV loans nationwide for over 40 years. MICA member companies have established the link between LTV and default risk. For a geographically diversified portfolio, compared to 80% LTV loans, 90% LTV loans require 2 to 3 times as much capital, and 95% LTV loans require 3 to 4 times as much capital. For a geographically concentrated portfolio, 90% LTV loans require 2.5 to 3.5 times as much capital as 80% LTV loans, and 95% LTV loans require 4 to 5.5 times the amount of capital. The presence of private mortgage insurance with adequate coverage brings required capital close to the same level as uninsured 80% LTV loans.

These capital calculations show the direct link between LTV and credit risk and the critical role effective credit enhancement plays

[2] FDIC Outlook, *In Focus: Housing Bubble Concerns and the Outlook for Mortgage Credit Quality*, Spring, 2004

in reducing such risk. They also demonstrate the critical importance of clear investor information on combined LTV. Without this information, investors may well misunderstand the real credit risk they assume in MBS comprised of structured loans, with the investor assuming he or she is purchasing an MBS where the overall LTV is well below the combined LTV that puts the MBS into the high-risk range. Further, the proposed requirement for disclosures related to credit enhancement may be far less useful than the SEC now contemplates because investors similarly cannot determine if credit-enhancement levels are deep enough to take on the additional credit risk implicit in structured mortgages.

MICA would be pleased to provide more information on structured mortgages to support the SEC's important work on ABS and market transparency. We appreciate this opportunity to comment.

Sincerely,

Suzanne C. Hutchinson