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Office of the Comptroller of the Currency – Docket ID OCC-2023-0008 / RIN 1557-AE78
Board of Governors of the Federal Reserve System – Docket No. R-1813 / RIN 7100-AG64
Federal Deposit Insurance Corporation – RIN 3064-AF29

Jan. 3, 2024

To Whom It May Concern:

On behalf of PMI Rate Pro[1], I would like to comment on the joint proposed rule-making referenced above that has commonly been referred to as the “Basel III Endgame,” which would implement the final components of the Basel III agreement. As a mortgage finance technology company, we are highly concerned about some of the elements of this proposal on the housing finance ecosystem. Potential homebuyers are already feeling the immense pressure of inventory shortages stemming from over a decade of insufficient new home construction, interest rate shocks that have frozen the market, and home prices that continue to rise despite increasingly unaffordable mortgage payments. Meanwhile, the sudden surge in interest rates and the continuing rate environment has resulted in a significant contraction among nonbank lenders. At the same time, depositories have found themselves significantly underwater on their MBS holdings and the value of the mortgages they hold in their portfolios.

There has already been enough damage done to the housing finance sector.

This is the wrong proposal, and it is at the wrong time.

Should this proposed rule be enacted in its current form, we would see some banks pull back from the mortgage market, or exit altogether. What’s more, the very structure of the proposal runs counter to efforts to reduce the racial homeownership gap by attacking the very parts of the mortgage market that represent the path to homeownership for minority homebuyers.

Turning to the rule itself, we would like to make the following observations regarding the proposed rule:

1. It reflects an incomplete understanding of the mortgage insurance industry.
2. There is a lack of consistency with current regulations.
3. It fails to encourage a prudent distribution of risk throughout the financial system.

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[1] PMI Rate Pro is a woman- and minority-led technology company that enables lenders to instantly pull risk-based pricing quotes from all six mortgage insurance companies, ensuring that lenders are able to obtain competitive pricing for their borrowers by eliminating the time and effort it takes to obtain six different quotes. PMI Rate Pro also has a risk allocation feature that allows lenders to manage their counterparty risk, allowing them to achieve the right balance between obtaining low rates and optimizing their counterparty exposures. These features are available through a web application, or via an API which gives lenders and software providers the ability to use a single integration to meet all of their MI needs.

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After discussing these three observations, we intend to propose an approach to mortgage insurance that balances solving for these issues while maximizing access to credit and minimizing the potential impact of risk-based capital on minority and LMI households.

***The proposed rule reflects an incomplete understanding of the mortgage insurance industry***

One of the rationales for not giving credit for mortgage insurance is the performance of the industry in times of stress. This would be a valid approach if the industry routinely failed to pay claims, and the companies were rendered insolvent during times of crisis.

As a result of the financial crisis, three mortgage insurers were forced to cease writing new business:

- Triad Guaranty – 2008
- PMI Mortgage Insurance Company – 2011
- Republic Mortgage Insurance Company – 2012

Currently, Triad is paying its claims in a mixture of 75% cash and 25% deferred payment obligation (DPO).[2] PMI is paying its claims in a mixture of 81% cash and 19% DPO.[3] RMIC is paying 100% of its claims in cash.[4]

With cash ranging between 75% and 100% of the claim payments, the idea that mortgage insurance is worth nothing is easily dismissed as being inconsistent with the facts.

What's more, there appears to be no acknowledgment of the reforms that have occurred due to the Federal Housing Finance Agency's Conservatorship of Fannie Mae and Freddie Mac. Previously, the binding constraints on the MI industry were:

- GSE MI eligibility requirements tied to insurer financial strength ratings published by rating agencies.
- Risk to Capital Ratio or Minimum Policyholder Position provisions at the state level equate to roughly a 25:1 ratio, without adjustment for the relative riskiness of the loans insured.

In 2015, Fannie Mae and Freddie Mac were directed by the FHFA to issue their revised Private Mortgage Insurer Eligibility Requirements (PMIERs).[5] The PMIERs were a significant step beyond their previous MI eligibility requirements and included both stringent operational requirements as well as risk-based financial requirements that were informed by the financial crisis. As a result of the introduction of the PMIERs, the MI industry substantially improved the amount of capital present and continues to maintain a healthy cushion above these requirements.

While state-level requirements are generally unchanged, the PMIERs have a minimum requirement that an MI company must maintain high-quality liquid assets at 5.6% of their Risk in Force (RIF).[6] This compares to the state-level requirement that equates to capital of 4% of RIF, and that capital can include illiquid sources such as investments in subsidiaries. And that's just the starting point – based on the risk of the insured loans, an MI company's GSE-imposed financial requirements can go higher.

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[2] https://www.tgic.com

[3] https://pmi-us.com

[4] https://www.rmic.com/Documents/Open/PH%20Letter.pdf

[5] https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Fannie-and-Freddie-Private-Mortgage-Insurer-Eligibility-Requirements-(PMIERs).aspx

[6] https://singlefamily.fanniemae.com/media/6151/display and https://sf.freddiemac.com/content/_assets/resources/pdf/requirements/pmiers.pdf

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The PMIERs also introduced operating requirements designed to keep the industry operating in a safe and sound manner. What's more, the GSEs' Rescission Relief Principles have instituted requirements that ensure that coverage disputes are significantly reduced, and these requirements are strongly aligned with the GSE Representations and Warranty Framework.

When one considers all of this, the conclusion is clear:

1. MI companies are less likely to be forced into runoff in periods of economic stress, thanks to improved capital levels.
2. Lenders are less likely to have disputes regarding their insurance coverage.
3. Even if an MI company goes into runoff, there is a clear history of them being able to pay a significant amount of their claims.

The fact that no credit is given for mortgage insurance in the proposal is not only inconsistent with the performance of the MI companies before reforms were instituted, but it appears to ignore the work of your fellow regulators at the FHFA.

***The proposed rule is inconsistent both internally and externally***

The proposed rule includes proposals that are inconsistent with the lack of credit given to mortgage insurance:

- Awarding a 50% risk weight to mortgages given to LMI or other historically underserved markets that "originated in accordance with prudent underwriting standards."
- Continuing to allow the standardized approach that awards a 50% risk weight to loans that are "prudently underwritten."

To understand why these proposals are inconsistent with the denial of credit for mortgage insurance under the proposed risk-based approach, one needs to understand what "prudently underwritten" means.

According to Appendix A to Subpart A 12 CFR 365, a prudently underwritten residential mortgage must have an LTV of less than 90% unless it includes credit enhancement in the form of either mortgage insurance or readily marketable collateral.[7] Thus, both of these proposals would provide credit for mortgage insurance, whilst the risk-based proposal explicitly excludes credit for mortgage insurance.

What's more, the credit provided is of a binary nature. A 90% LTV loan without MI would not be prudently underwritten, and thus have a 100% risk weight. Meanwhile, that same loan with MI coverage of a mere 1% would receive the 50% risk weight coverage that is granted to prudently underwritten mortgages. This causes inconsistency and a capital treatment that invites arbitrage through the purchase of de minimis mortgage insurance cover.

Is this really a better situation than simply granting credit for MI in the risk-based approach?

We need only look to the Federal Housing Finance Agency, which issued the Enterprise Regulatory Capital Framework (ERCF) rule, for an example of how MI could be successfully integrated into a capital framework. This rule is intended to create a banklike capital standard for the GSEs, while making allowances for the fact that the GSEs are not banks. In the ERCF, mortgage insurance is given credit for its ability to reduce loan loss severity, and the rule includes a complex series of calculations that reflect the coverage level, counterparty strength, and terms of coverage.

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[7] https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-365/subpart-A/appendix-Appendix%20A%20to%20Subpart%20A%20of%20Part%20365

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Speaking of reducing loss severity, it should also be noted that in the Current Expected Credit Loss standard promulgated by the Financial Accounting Standards Board, mortgage insurance that is structurally attached to the loan at the time of origination is given credit toward reducing the level of reserves that a bank must book.[8] This credit is obviously adjusted based on the terms of the contract and counterparty strength, but the message is clear: mortgage insurance provides value.

It is illogical that mortgage insurance is not given credit in your risk-based framework when policymakers seem to universally agree that mortgage insurance provides value. Especially when you have inadvertently agreed with this concept only a few pages after asserting that MI should not be given credit.

***The proposed rule would encourage concentration of risk within banks, rather than distributing it to diverse sources of private capital***

It is a basic principle of a free market system that participants will act in their own best interests. Should this proposed risk-based approach be enacted, some banks may choose to exit the mortgage lending business, but those that remain will face the following reality:

1. Increased capital requirements for mortgages; and
2. No capital relief for de-risking their mortgage portfolio using credit enhancement.

Even though the increased capital requirements are supposed to improve safety and soundness, the same thing can be accomplished with a regime that incentivizes the distribution of mortgage credit risk via capital relief for credit enhancement such as mortgage insurance. The existence of the mortgage insurance industry, as well as the GSEs' credit risk transfer programs, demonstrate that there are significant amounts of private capital willing to take on mortgage risk.

In a regime that encourages the distribution of risk, we have a diversity of capital models and risk appetites that enable counterparties to compete for risk. This has the result of not only lowering costs for borrowers but also means that we are not putting our eggs into one basket. In such a system, it's easy to tap sources of capital that specialize in mortgage credit risk, and the ebbs and flows of this capital can provide valuable signals to the banks that originate mortgages.

In contrast, the walled garden proposed in this rule results in an accumulation of risk, putting banks at increased risk. What's more, the ability for banks to charge extra for their increased capital requirements (borrowers tend not to cross-shop as much as they should) means a false sense of security at best and a degradation of lending standards to meet revenue targets at worst.

And while banks may have some expertise when it comes to mortgages, would they not be better off being able to tap the expertise and capital of the mortgage insurance industry, the reinsurance industry, and the investors in capital markets credit risk transfer? All this would be possible if the proposed rule allowed for credit for mortgage insurance and reformed the standards and risk weights around eligible guarantors.

Could some of this capital flow to banks through other means? Yes, but it is inefficient. Could banks take cues from observing these market participants? Yes, but they would likely be late to the party. Would the increased capital requirements be a cost-effective solution to improving safety and soundness? No.

***Our proposal is to give appropriate credit to mortgage insurance in a manner that balances other policy objectives***

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[8] https://www.mgic.com/blog/reduce-impact-of-cecl-with-mortgage-insurance

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As a starting point, it is our view that alignment is good. In the Conventional mortgage space, it's understood that loans that are sold to the GSEs require mortgage insurance if the LTV is above 80%. While we would not be opposed to greater usage of mortgage insurance for loans held on depository balance sheets, we think the best method of achieving this is the carrot instead of the stick. Therefore, whether one uses a risk-based approach or the Standardized Approach, credit for mortgage insurance should begin at 80% LTV – if not lower.

Next, the time has come to close the capital arbitrage that exists as the result of the Standardized Approach. At present, a 90% LTV loan would have a risk weight of 100% without MI, but a thin MI policy that only covers 1% of the loan balance would reduce that risk weight to 50%. The result is that an 8% capital requirement becomes a 4% capital requirement thanks to MI, which provides minimal economic value. Instead, credit for mortgage insurance should be scaled based on the amount of coverage provided, as we see with the ERCF.

While the ERCF utilizes hard-coded coverage levels, banks should be free to pick the coverage levels that make the most sense to them. Therefore, utilizing the "down to" LTV approach would be most appropriate when evaluating the impact of MI on a loan. This calculation is performed by multiplying the LTV by one minus the coverage percentage to determine an equivalent LTV. For example, a 90% LTV loan that had 10% coverage would be the equivalent of an 81% LTV mortgage, as [90% * (1 – 10%)] = 81%.

Next, a counterparty risk adjustment should occur – the ERCF provides a good starting point, with a further adjustment based on how well a bank has diversified its MI counterparty exposure. The goal should not be to encourage everyone to flock to a single counterparty.

Finally, there's the question of how to make everything risk-based without harming minority and LMI borrowers.

The solution to this is quite simple: make the capital requirement risk-neutral, but allow capital relief to be dictated by the transfer of risk.

Under such a system, a bank does not have a disincentive to lend to borrowers who are perceived as being riskier, but they do have an incentive to distribute that risk to other counterparties. Since MI companies and CRT market participants price on a risk-adjusted basis, capital relief and the cost of capital relief will be aligned, and banks will retain the option to carry a bit more risk if needed to help offset the cost to the borrower.

In summary:

- Capital relief for MI to begin at 80% LTV (or lower)
- The benefit should be based upon the actual coverage level, perhaps looking at the "down to" calculation.
- Counterparty risk adjustments should be included to encourage a diversity of counterparties.
- The standard should be risk-neutral at the loan level, with a risk-based MI benefit.

***Conclusion***

While this rulemaking is an important step in finalizing the implementation of Basel III, it is not the right approach. Introducing excessive risk weights beyond what other countries have implemented in conjunction with ignoring an important source of risk-absorbing private capital would be a mistake that could severely damage the housing finance ecosystem. We encourage you to not only revise the proposal to be more in line with what we see in the ERCF but also to consider some of the alternatives we proposed.

Thank you for your consideration of our comments, and we would be happy to discuss them with you further.

Sincerely,

Nomi Smith, CEO
PMI Rate Pro