Mortgage Insurance Companies of America

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February 22, 2010

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N. W.
Washington, DC 20429

RE: ***RIN # 3064-AD55***: *Proposed Treatment By The FDIC As Conservator Or Receiver Of Financial Assets Transferred By An Insured Depository Institution In Connection With A Securitization Or Participation After March 31, 2010* ***(Safe Harbor Proposal)***

Dear Mr. Feldman:

The Mortgage Insurance Companies of America (MICA), the trade association representing the US residential mortgage insurance (MI) industry, offers its comment on the Safe Harbor Proposal. MICA notes at the outset its strong support for the FDIC's announced intention to extend its safe harbor beyond the March 31st end date[1]. The issues raised by the Safe Harbor Proposal are many, the interactions are complex, and a vigorous debate is ongoing regarding the best way to restart private securitization markets without encouraging behavior that puts the Deposit Insurance Fund at risk. An extension of the safe harbor would permit this debate to reach critical conclusions without exposing the FDIC to risk because private-securitization markets remain moribund.

The Safe Harbor Proposal presents various means to improve the securitization process by safeguarding asset quality, imposing structuring limitations, enhancing disclosure, and clarifying service provider roles and authority. While each has its merits, MICA has an especially strong interest in pursuing measures to improve and maintain mortgage loan quality because MIs are in a first-loss position (after borrower equity) on high loan-to-value (LTV) mortgages. In that regard, MICA is pleased to see the Safe Harbor Proposal's endorsement of MI as an acceptable form of loan-level credit risk mitigation. MI is a regulated, counter-cyclical source of loan level protection generally provided for the life of a mortgage loan following an independent, objective underwriting assessment performed before a loan is insured.

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[1] *See.e.g.,* Safe Harbor Might Go Beyond March End Date, Krimminger Says, *Structured Finance News* (Feb. 2, 2010), at http://www.structuredfinancenews.com/news/-202515-1.html.

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It is for this reason that the recent report from the Joint Forum of global banking, securities and insurance regulators endorsed (public and private) mortgage insurance as an important element of a reformed mortgage origination and securitization framework.[2] MICA believes that thoughtful underwriting and disclosure standards included by the FDIC in the Safe Harbor will help to ensure that mortgage securitization does not migrate to less-regulated institutions or remain predominantly Government supported. Sound underwriting practices are fundamental to any sustainable private market revival. MICA's recommendations below thus emphasize adoption of meaningful underwriting standards and the importance of a disciplined underwriting process, with particular reference to MICA's core market of high LTV residential mortgage loans. Subject to consistent supervisory and regulatory oversight, MICA believes this combination of clear standards and strong oversight and enforcement should be tried before considering mandatory risk retention requirements which can undermine the FDIC's securitization goals.

Mortgage underwriting standards should be an important part of the Safe Harbor

Question 17 asks whether specific origination standards should apply to loans eligible for the safe harbor. Related to this, the Comptroller of the Currency and others have noted the contribution of poor underwriting to the housing market downturn and have called for the adoption of minimum mortgage credit underwriting standards.[3] MICA strongly supports the incorporation of underwriting standards into the Safe Harbor. However, the Safe Harbor Proposal must address at least four issues:

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[2] THE JOINT FORUM, BASEL COMMITTEE ON BANKING SUPERVISION INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS C/O BANK FOR INTERNATIONAL SETTLEMENTS CH-4002 BASEL, SWITZERLAND, **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**. 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).").

[3] See JOHN C. DUGAN, SECURITIZATION, 'SKIN-IN-THE-GAME' PROPOSALS, AND MINIMUM MORTGAGE UNDERWRITING STANDARDS (Feb 2, 2010), *available at* http://www.occ.treas.gov/ftp/release/2010-13a.pdf.

- Institutional scope – The FDIC's reach extends only to insured depository institutions, so any introduction of minimum underwriting standards should be coordinated with other regulatory authorities to cover as much of the residential mortgage origination market as possible. Currently, Fannie Mae, Freddie Mac and Ginnie Mae account for over 95 percent of the residential mortgage-securitization market while institutions regulated by the FDIC, Federal Reserve and OCC generate much of the new mortgage business for these government-related securitizers. Additionally, the SEC has announced its intention to review the effectiveness of its efforts to monitor residential mortgage backed securities (RMBS) issuance and trading. A coordinated approach among all these regulators will have a significant impact on the existing market.

- Underwriting standards – The Safe Harbor Proposal notes prior interagency guidance on mortgage underwriting standards, mostly related to "non-conforming" mortgages (*i.e.*, mortgages not conforming to the underwriting standards used by Fannie Mae and Freddie Mac). Other sources of appropriate underwriting are also available from Fannie Mae, Freddie Mac, the Federal Housing Administration and other public and private mortgage insurance and guarantee programs. Whichever standards are selected, they should establish minimum standards for documenting and verifying income and assets, create sustainable debt capacity limits, prohibit unduly risky terms (such as loans with negative amortization or short term "teaser" adjustable rates), and require loan- level credit enhancement on loans with combined loan to value ratios (CLTVs) above 80%. MICA has set forth more specific thoughts regarding down payment requirement below.

- Process validation – Originator adherence to minimal underwriting standards must be subject to verification in order to have the desired effect on market behavior. MICA believes this can occur since, consistent with the institutional scope point noted above, institutional supervisors already have review protocols, and the SEC could prescribe a similar validation process for any remaining gaps in the market.

- Non-compliance – **Question 31** in the Safe Harbor Proposal raises the important issue of what consequences should apply for loans not originated in compliance with applicable law. First, "compliance" within the context of the Safe Harbor Proposal should refer to the underwriting standards only, not the full range of applicable laws for which penalties and/or remedies already exist for non-compliance, in addition to contractual rights arising from the securitization documents. Second, a transaction should lose protection of the Safe Harbor only if the parties seeking protection are unable to show a commercially reasonable, good faith effort to ensure that underwriting standards were followed for the loans, including that relevant contractual provisions such as repurchase rights were pursued for non-compliant loans, and that loss of the Safe Harbor would be in the best interests of the Deposit Insurance Fund. In practice, diligence procedures are customary (and likely will become more rigorous as a result of losses experienced as a result of the downturn) and parties seek to enforce contractual rights to minimize losses. The new constraint here would be the introduction of minimum underwriting standards.

MICA believes that underwriting standards as suggested above could substitute for credit risk-retention provisions, especially in light of the serious questions that have been raised concerning such provisions. In this regard, **Question 28** asks whether the sponsor of a mortgage securitization should retain an economic interest in a material portion of the credit risk of the financial assets being securitized. MICA notes that recent analysis of mandatory risk retention requirements by the IMF[4] and academicians[5] has raised serious concerns as to how effective risk retention requirements could be implemented without either shutting down the securitization market or allowing for arbitrage of accounting and regulatory capital requirements by securitization sponsors so as to undermine the goals of risk retention. The IMF work has also clarified that "the decision for regulatory retention requires more in-depth analysis than simply assigning a 5 percent formula."[6] For these reasons MICA suggests that the concept of a mandatory risk retention requirement imposed on either loan originators or securitizers requires a great deal of additional analysis before it is implemented and that alternatives to mandatory risk retention such as meaningful underwriting standards should be adopted in the Safe Harbor proposal.

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[4] IMF Survey September 21, 2009, *Chapter 2 Restarting Securitization Markets: Policy Proposals and Pitfalls.*

[5] Fender, Ingo, and Janet Mitchell, 2009, "Incentives and Tranche Retention in Securitization: A Screening Model" (unpublished; Bank for International Settlements). Available via the Internet: www.bis.org/bcbs/events/cbrworkshop09/fendermitchell.pdf. and Kiff, John, and Michael Kisser, forthcoming, "Optimal Retention Policy and Capital Requirements," IMF Working Paper (Washington: International Monetary Fund). As cited in Ibid., p.25.

[6] IMF Survey, op.cit., p.30.

MICA also notes that a reliance on underwriting standards is similar to the "qualified mortgage" standard proposed in various Congressional efforts to address predatory lending and financial reform[7]. Should the FDIC decide to rely on both underwriting standards and some form of credit risk retention, then, MICA believes that a qualified mortgage standard should be established and mortgages meeting this standard should be exempt from any credit risk-retention requirements.

Additionally, MICA offers three other recommendations regarding minimum underwriting standards:

- <u>No "piggyback" second mortgages should be allowed</u>. In terms of painful lessons learned, the use of simultaneous second liens or "piggyback" mortgages deserves comment. "Piggyback" mortgages 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 either entity can 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.

  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

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[7] See for example the Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009), passed by the House of Representatives Dec. 11, 2009. A risk retention requirement that specifically exempted "Qualified Mortgages" would serve the policy objective of ensuring prudently underwritten mortgages without unduly complicating the mechanics or economics of mortgage financing. Specifically, MICA would urge that such Qualified Mortgages be defined as residential, single family mortgages that do not allow for negative amortization, that have a maximum debt to income ratio of 41 percent, that require full documentation of income and assets, that have a fixed or long term (7 year) adjustable interest rate, that are underwritten to the fully indexed interest rate and that, in the case of such loans with an initial combined loan to value ratio above 80%, have mortgage insurance or a comparable credit enhancement at the time of origination.

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

banking organizations.[9] The agencies finally took action on home equity loans and lines of credit in 2005[10], but the guidance at that time was implemented inconsistently. As the FDIC knows all too well, these loans are a serious financial-market risk and an impediment to mortgage-loan modifications that prevent otherwise-avoidable foreclosures. Piggyback loans are both dangerous to the borrower and the lender and unnecessary. Thus, MICA recommends that underwriting standards adopted for purposes of the Safe Harbor prohibit any residential mortgage transaction involving a piggyback second lien.

- <u>Enhanced reporting on all second liens and/or "additional liens" clause</u>. Home equity loans and lines of credit have combined with piggybacks to become significant obstacles to ongoing mortgage loan modification efforts and restoring investor confidence in the integrity of bank balance sheets. Of course, all second liens are problematic because, by definition, they increase borrower indebtedness and, thus, reduce home equity.[11] The Joint Forum paper referenced above pointed to equity extraction as a major mortgage-risk factor.[12] To address this, MICA recommends that the FDIC include in its Safe Harbor disclosure requirements an express mandate for insured depository institutions to notify the FDIC in quarterly reports of all second liens and lines of credit taken out on all first liens, whether or not the first lien remains in the bank's portfolio. This will permit the FDIC and other parties to monitor these risks on a loan-by-loan basis and determine when an insured

[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.
[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] As the housing crisis has developed, more studies have shown the close correlation between the availability of second lien financing and mortgage defaults. See *e.g.*, MICHAEL LACOUR-LITTLE ET AL., FOLLOW THE MONEY: A CLOSE LOOK AT RECENT SOUTHERN CALIFORNIA FORECLOSURES**,** (May 23, 2009), *available at* http://www.areuea.org/conferences/papers/download.phtml?id=2133.
[12] Joint Forum, op. cit. pp.16-17 "Equity extraction limitations contribute to housing market stability, deter irresponsible financial behavior that puts homes at risk, and promote savings through equity build. (ff. While it might be argued that supervisors are not responsible for protecting borrowers from themselves or promoting such savings, to ignore this important aspect would be irresponsible from a public policy standpoint). They effectively limit the fallout associated with unfettered "monetization" of the equity gained during periods of rapid home price appreciation, especially since that appreciation may not prove sustainable."

depository institution is taking undue risk related to second liens that must be addressed through supervisory action.

- Mandatory credit risk mitigation on all loans with CLTVS above 80% 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. As recognized in the Safe Harbor Proposal, these loan-level forms of credit risk mitigation place capital at risk and provide a second underwriting and other controls that protect the FDIC, along with 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 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 is put at risk on these mortgages it ensures appropriate borrower and FDIC protection.

Reliable loan-level credit risk mitigation should be allowed in the Safe Harbor.

Question 8 of the Safe Harbor Proposal seeks views on the treatment of external credit support and the nature of qualifying asset-backed securitizations for the Safe Harbor. MICA supports recognition of external credit support with appropriate qualifications. External credit supports increase credit availability by providing additional capital that promotes credit availability and provides the FDIC with protection in the event of failure of an insured depository institution. Mortgage insurance (whether provided by private or public entities) ensures high-LTV residential mortgages are managed in a way that protects and preserves sustainable home ownership[13]. For these

[13] MICA's members are unique among large holders of primary mortgage risk because mortgage insurers are required to contribute 50% of every premium dollar to a contingency reserve that generally cannot be touched for ten years. This structure ensures that capital is amassed during good economic times is available to protect MI

reasons, MICA endorses the FDIC's Safe Harbor Proposal decision to recognize the value of loan-level MI.

The Safe Harbor proposal also suggests that other forms of loan-level guarantees might be acceptable in addition to MI. However, to maintain comparability with MI, MICA urges that the FDIC clarify (at least within the context of residential mortgages) that "guarantees" or any other form of external credit support provider be capitalized, regulated, demonstrate proven capacity to ensure prudent loan origination and satisfy its obligations, and be offered by a bona fide third-party unrelated to the originator or securitizer. Guarantees offered by affiliated parties undermine the value of true external credit support and should be prohibited under the Safe Harbor.[14]

MICA also recommends that credit default swaps (CDS) not be considered as acceptable forms of guarantee for purposes of the Safe Harbor. CDS have been a source of profound systemic risk in the current crisis, with the regulatory framework required to correct this problem still only in proposed form in the U. S. and most other national regimes. The Joint Forum paper cited above rightly details an array of supervisory and capital problems in the CDS sector. For these reasons, a prudent and cautious attitude regarding CDS is appropriate.

Other provisions of the Safe Harbor Proposal (Disclosure and NPV Test)

In **Questions** **9** through **17** the FDIC requests comment on the necessary quality and quantity of information disclosures in securitization issuance and reporting. MICA supports the FDIC's broad goal of enhanced ABS transparency, which reduces information asymmetry, enhances market-pricing efficiency and promotes informed investor decision-making. The FDIC will also be able to ensure that any ABS provided a safe harbor is in fact prudent if the underlying loan-level disclosures are sufficient, transparent and objective, permitting both it and other bank supervisors to validate bank underwriting and securitization practice without burdensome examinations that may divert needed supervisory resources.

MICA believes that accurate and complete disclosure of risk factors in mortgage underwriting is necessary to prevent the return of

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solvency and new-business capacity even under conditions of acute stress such as those now evident throughout the U.S. mortgage market.

[14] For example, the Japanese mortgage market relied extensively on affiliated guarantee companies that, in retrospect, proved unable to exercise independent underwriting judgment or accumulate the capital needed to honor their counterparty claims without parental support.

aggregators which create a demand for imprudently underwritten primary loans. These aggregators use weak disclosure requirements to place within their pools of mortgages very high risk products that do not reflect the risk attributable to other mortgages within the pool. The ability of investors or their agents to conduct a thorough analysis of mortgage pools down to the loan level and track their performance back to the various agents involved in the origination process is just as important at the securitization stage as preventing the return of dangerous mortgages practices in the primary mortgage underwriting process. MICA suggests that arguments against full and comprehensive disclosure which hinge on excessive reporting cost burdens should be discounted by the regulators when compared with how costly asymmetric information about mortgage pools has been to investors and how the resulting uncertainty virtually shut down the private securitization market when investors realized that they did not know the true nature of the mortgages comprising their MBS investments.

Reflecting the vital role of ABS transparency, various initiatives are currently pending in this area.[15] MICA recommends to all regulatory agencies looking at disclosures relating to residential mortgage backed securities that they focus on the importance of disclosing those factors that have been shown to be the drivers of mortgage credit risk. As an industry serving holders of mortgages with low initial borrower down payments, we have found the key drivers of credit risk to be the amount of initial borrower equity in the property underlying the mortgage (including any simultaneous second liens), changes in borrower equity over time generated by changes in house price as well as extraction of equity through subsequent home equity borrowing and the affordability of the mortgage to the borrower both at the time of mortgage origination and subsequently over the life of the mortgage. If disclosure standards do not allow an investor or analyst to identify and measure these factors initially and on an ongoing basis, then those standards are insufficient. MICA believes that ABS disclosure standards for residential mortgages should pass this "key driver" test to enjoy the Safe Harbor.

MICA also notes that as important as full and accurate disclosure is to accomplishing the goals of re-establishing a liquid and

[15] The aforementioned House-passed legislation includes a set of detailed requirements on ABS transparency (see supra note 4, Sec 1503). Further, the chairman of the Securities and Exchange Commission (SEC), Hon. Mary Schapiro, has indicated that the SEC will shortly propose an array of new ABS disclosures, rules the SEC will issue under current law to enhance ABS practice and then review if additional statutory authority is provided (see MARY L. SCHAPIRO, EMBRACING THE CHANGE (Jan. 20, 2010), *available at* http://www.sec.gov/news/speech/2010/spch012010mls.htm.

safe private securitization market, disclosure is not sufficient unto itself to accomplish this goal. The underwriting standards and other points we note above remain critical to the re-establishment of a private securitization market. MICA looks forward to commenting on the proposed disclosures as they are presented by the regulatory agencies.

Finally, Question 19 seeks comment on the authority of servicers to mitigate losses on mortgage loans consistent with maximizing the net present value (NPV) of the mortgages, as defined by a standardized net present value analysis. MICA members work closely with mortgage servicers regarding loan loss mitigation activities. In this regard MICA notes that allowing mortgage servicers to rely on a standard NPV calculation could result in loan modifications being denied to borrowers who have MI on their loans while offering modifications to borrowers who opted for riskier products (such as piggybacks) that were designed to avoid the MI requirement. MICA urges the regulators to consider that loss mitigation practices focusing on NPV calculations should not encourage unnecessary risk taking on new mortgage originations or loan modifications.

Conclusion

For the reasons detailed above, MICA endorses the FDIC's cautious approach to securitization in its revision of the Safe Harbor. MICA supports the FDIC's efforts to work with Congress and the other regulators to craft an approach that, while protecting the DIF, does not adversely affect future prospects for private securitization markets. This is particularly important for the mortgage sector which depends heavily on efficient secondary markets. To that end, MICA strongly recommends creation and adoption of minimum mortgage credit underwriting standards as an immediate response to learning from the lessons of the past and (still painful) present. MICA also endorses the role of MI as set forth by the FDIC in the Safe Harbor and would be pleased to provide any additional data that would be of assistance as the FDIC advances its initiative.

Sincerely,

Suzanne C. Hutchinson