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October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, D.C. 20219
Docket ID: OCC-2012-0009
RIN 1557-AD46

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1442
RIN 7100 AD 87

Robert E. Feldman, Executive Secretary
Attention: comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.,
Washington, D.C. 20429
RIN 3064-AD96

Re: **Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets;
Market Discipline and Disclosure Requirements**

Dear Sir or Madam:

Essent Guaranty, Inc. ("Essent") is a private mortgage insurance company (a "PMI" provider), providing credit-risk mitigation on single-family residential mortgage loans for banks, and other lenders and investors, throughout the United States. Essent became the first new entrant into the private mortgage insurance industry since the 1990s when in 2010 we began writing PMI. Essent currently serves hundreds of bank clients, and other lenders, in meeting their needs for reliable mortgage insurance coverage. Our letter comments on new capital rules for banks in 77 FR 52889 (August 30, 2012), hereinafter referred to as the "*Standardized Approach*" proposed by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal

Reserve System ("Board") and the Federal Deposit Insurance Corporation ("FDIC"), collectively, the "Agencies."

We specifically address Question #6 in the *Standardized Approach* as to: (1) whether banking organizations should be allowed to recognize PMI for purposes of calculating the loan-to-value ("LTV") ratio of a residential mortgage exposure; and, (2) the criteria the Agencies should use to ensure that only financially sound PMI providers are recognized.

Financially Sound PMI Should be Recognized

The Agencies should allow banks to recognize PMI from a provider that meets an established set of prudential standards acceptable to the Agencies (a "Qualified PMI" provider, or "QPMI"). Banking regulations support the use of credit risk mitigation, and PMI is a credit risk mitigant that plainly reduces the risk of economic loss from the underlying mortgage.¹ PMI reduces the severity of loss (i.e., loss-given-default, or "LGD") on a mortgage loan by the amount specified in the contractual terms of the PMI coverage. A bank with PMI covering its residential mortgage loans is in a demonstrably safer risk position than it is with respect to comparable uninsured loans.

A PMI provider's capacity to pay claims comes from its premiums, reserves and capital. The claims-paying capacity of a PMI company is not required to support other risks because the business of PMI providers is limited by law to insuring only single-family mortgage default risk and the claims of policyholders are senior to all other obligations. Claims-paying capacity is supported by a distinctive reserving model that requires contingency reserves of 50% of earned premium income for each book year in addition to the establishment of GAAP reserves for expected losses on loans in default. These contingency reserves must be held for ten years and can generally only be released earlier during periods of unusually high losses. The contingency reserve framework addresses the long-lived and cyclical nature of well-underwritten mortgage credit risk, with defaults and losses normally modest but capable of increasing very significantly under conditions of material economic and housing market stress. In recognition of these stress periods, this prudential reserving methodology creates a countercyclical component to a PMI provider's capital structure.

In addition to the direct reduction of LGD, PMI also provides credit risk mitigation benefits by serving as a "second set of eyes" for lenders and mortgage investors. PMI companies are third-party, arms-length and long-term holders of a portion of the credit risk on insured residential mortgage loans. With their capital at risk in the event of claims caused by mortgage defaults, the economic incentives of PMI companies align with actions that help ensure prudent mortgage lending, such as establishing underwriting guidelines, directly underwriting loans for mortgage insurance eligibility, approving lenders with sound loan origination practices, conducting timely quality control reviews and on-going loan performance monitoring. The economic incentives of PMI providers also align with appropriate loss mitigation for troubled borrowers, such as loan modifications and foreclosure alternatives that may minimize loss if default occurs.

The PMI industry did mitigate risk and reduce mortgage investor losses through the unprecedented stresses of the recent crisis, as we estimate that claims already paid and established GAAP loss reserves for future expected claims on delinquent loans total \$50 billion. For those companies unable to continue writing business due to capital leverage ratios falling below prudential levels, resolution has been orderly, conducted under state regulatory mandates to protect policyholders, and without a need for extraordinary government intervention.²

The recent crisis demonstrated that the fundamental framework of the PMI model worked, but it also exposed the need for enhancements. The key “lessons learned” of the crisis for the PMI industry are (1) the need for capital levels that reflect the potential for economic stress and the level of risk of the insured portfolio so that claims can be fully paid, (2) transparent and fair contractual terms for the payment of claims and, (3) prudent underwriting of risk. These lessons are not isolated to the PMI industry; they were abundantly evident across all major sectors of the mortgage market and necessitated significant reforms. Therefore, we believe that capital recognition should be permitted if these issues are addressed, and we propose approaches to each in the following section that we believe collectively establish sound prudential standards for PMI provider recognition.

PMI Providers Should Meet Sound Prudential Standards

We recommended specific sound prudential standards to determine if a PMI provider should be deemed a QPMI. Our proposed prudential standards for assessment of PMI providers address (1) capital adequacy, (2) sound contractual terms, and (3) prudent underwriting of mortgage insurance risk. Each prudential standard is addressed in more detail below.

Broad criteria for PMI provider recognition should be incorporated in the regulation implementing the *Standardized Approach*. Such criteria could be made more detailed and further clarified in specific supervisory guidance and examination manuals. Banks would document compliance with the criteria through due diligence to determine which PMI providers meet the prudential standards and merit QPMI recognition, which would be subject to the examination process. The appropriate level of bank due diligence would take into consideration the size and complexity of the bank and the size of its exposure to a PMI provider. This proposed framework for bank determination is analogous to the OCC framework that allows banks to make determinations as to whether an investment security is “investment grade” but subject to the criteria and supervisory/examination guidance established by the Agencies.³ After initially approving a PMI provider as a QPMI, banks would monitor continued eligibility on a periodic basis so as to identify the weakening financial condition of a PMI provider and remove QPMI status on a timely basis. The Agencies should permit banks to recognize partial capital credit for loans held by banks that are insured by a PMI provider that attained QPMI status but has subsequently fallen out of compliance with the QPMI prudential standards.

Prudential Standards for QPMIs

(1) Capital Adequacy

Capital adequacy assessment of mortgage credit risk must consider the long life of the risk, changes in origination practices and credit risk mix that occur over time, and the potential for adverse changes in the economy. A number of methodologies can be used to develop these assessments. For purposes of developing a sound, transparent and verifiable methodology to establish capital adequacy criteria for recognition as a QPMI, we propose use of a stress test. The stress test would project claim losses under conditions of severe economic and housing stress on the PMI provider's insured book of business, estimated from the actual performance of MI insured loans in the most recent crisis. A QPMI must have sufficient claims paying capacity to fully pay the estimated stress claims. An appropriate methodology would reflect two primary sources of claims paying resources for performing insured loans; (1) future net earned premium income and (2) capital.⁴

The stress test should assume that the PMI provider is in runoff (see endnote 5) to ensure that no benefit is given to potential net premium income from mortgage insurance yet to be written and that the PMI provider's financial condition at any point of time is assessed only giving consideration to its existing claims paying resources in relation to insured risk.

The stress test would be applied to all the exposure in the PMI provider's insured portfolio and the results would be aggregated into a cumulative required capital metric, to be compared to the PMI provider's actual capital.⁵ Each PMI provider seeking QPMI qualification would run the stress test on its own business and make the results publicly available in a format acceptable to the Agencies. In addition, the results should be validated by a credible independent third-party and PMI providers would make available to banks the information needed to conduct due diligence.

An illustration of the stress test methodology is provided in Schedule A attached.

We are not submitting a specific stress test with this comment letter, although we have done research and modeling focused on the capital requirements for newly insured loans which inform the perspectives we provide in this comment letter. A stress test of the type we propose should be developed and validated, including validation through other sound methodologies that confirm the reasonableness of the model's results, with robust input from the Agencies. We do understand that other PMI industry comments will propose a specific model and Essent would be pleased to support an effort promptly after submission of the comment letters to work collaboratively with the Agencies and the PMI industry to finalize a stress test methodology.

However, it will take some time to develop an acceptable stress test and in the interim the Agencies may wish to consider other benchmarks to assess the capital adequacy of PMI providers using information that is generally publicly available. Essent has conducted research and modeling on the appropriate capital levels for loans insured post-crisis (i.e., 2009 and later) using a variety of analytical methods. Multiple methodologies were deployed with a perspective that capital assessments supported by more than one sound methodology give greater confidence in the results. Our analyses yield reasonably consistent results – capital in the range of 5%-6% of insured risk-in-force is robust to fully pay claims in a stress scenario of the magnitude recently experienced.⁶ These results are inherently sensitive to the nature of the risks evaluated, which in this case reflects that post-crisis era insured loans in the PMI market have very strong risk attributes (i.e., approximately 90% average LTV, 760 average FICO, and fully documented). For these risks, capital levels in the range of 5%-6% of insured risk-in-force would support very high stress default rates, on the order of 13%-15%, which are consistent with our observations for actual and projected remaining claim rates experienced by loans of this type in the recent crisis. The 5%-6% range would also serve as a useful benchmark to confirm the results of a stress test methodology to be used going forward on similar risks.

As further context to our views on capital requirements for new business, state insurance regulations have traditionally established a minimum level of capital to risk-in-force of 4%.⁷ Our analyses strongly indicates that higher capital ratio requirements are consistent with establishing that MI companies would be able to fully pay claims under conditions of economic stress such as those of the recent crisis. The capital adequacy assessment of legacy pre-2009 books require additional analysis which we have not conducted.

Should the profile of new insured loans migrate materially toward higher (or lower) risk loans, appropriate capital levels would need to be higher (or lower) than 5%-6% of risk-in-force. However, we do not anticipate a material PMI credit risk profile change in the next year, and during this period an appropriate stress test can be established. Factors expected to result in a stable PMI risk profile for the coming year include more prudent risk management manifestly evident in the PMI industry, a constrained risk appetite by major market participants who purchase or guaranty PMI-insured loans, and the expected implementation of new regulatory standards, such as the Qualified Mortgage rule, which will strongly emphasize the ability of the borrower to repay their loan in the underwriting of mortgages in the U.S. market.

The components of capital should also be evaluated to identify if there is material reliance on low quality sources of capital. Low quality sources of capital include capital that may be illiquid or intangible assets that may not be readily available claims-paying resources. In addition, capital from sources such as non-MI affiliates that may also be supporting material amounts of non-mortgage risk exposures, or capital in subsidiaries that is not readily accessible to the PMI provider when needed to pay claims, are also low quality sources of capital. Low quality sources of capital should be deducted from capital for purposes of assessing capital adequacy.

(2) Sound Contract

For capital recognition, the Agencies and banks will want to only recognize PMI providers whose contractual terms of coverage (the “Master Policy”) ensure that claim payments will be paid fairly and timely. Essent has been a leader in responding to the issue of MI coverage rescissions by revising our Master Policy terms and issuing an endorsement to the Master Policy called *Clarity of Coverage*.[®] *Clarity of Coverage* was developed in collaboration with major banks that experienced rescission issues. The additional contractual assurances provided by Essent’s *Clarity of Coverage* (see Schedule B, attached) apply to every loan Essent insures for the life of the coverage, protecting mortgage investors, servicers, originators and anyone exposed to loss from non-payment of a valid MI claim.

We observe that master policy terms elsewhere in the PMI industry are also evolving in response to the market’s insistent demand for sound contractual terms. Notwithstanding these developments, we propose that to be deemed a QPMI, a PMI provider must transact insurance under an insurance contract that meets the following minimum requirements:⁸

- (1) Is written;
- (2) Is unconditional, the enforceability of which is dependent on some affirmative action on the part of the policy beneficiary (for example, meeting servicing requirements);
- (3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference residential mortgage loan exposure;
- (4) Gives the beneficiary a direct claim against the PMI provider;
- (5) Is not unilaterally cancelable by the PMI provider for reasons other than the breach of the contract by the insured or beneficiary;
- (6) Is legally enforceable against the PMI provider in a jurisdiction where the PMI provider has sufficient assets against which a judgment may be attached and enforced;
- (7) Requires the PMI provider to make payment to the beneficiary on the occurrence of a default (as defined in the policy) of the obligated party on the reference residential mortgage loan exposure in a timely manner without the beneficiary first having to take legal action to pursue the PMI provider for payment;
- (8) Does not increase the beneficiary’s cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference residential mortgage loan exposure;
- (9) Does not prevent a recovery on the basis of misrepresentations in the application unless (i) fraudulent; or (ii) material either to the acceptance of the risk or to the hazard assumed by the PMI provider; or (iii) the PMI provider in good faith would either not have issued the policy, or would have not issued the policy or extended coverage in as large an amount or at the premium rate as applied for or would not have provided coverage with respect to the hazard resulting in the loss if the true facts had been known to the insurer as required by the application for the policy;

- (10) Is not provided by an affiliate of a banking organization, unless the affiliate is an insurance company that (i) neither controls nor is controlled by the banking organization, and (ii) is subject to consolidated insurance supervision and regulation as a PMI provider;
- (11) Requires that when the MI underwrites the loan there cannot be breach of contract for underwriting errors;
- (12) For banks that underwrite the loan under authority delegated by a PMI provider, require that after an appropriate period of timely payments by the borrower, the PMI provider cannot rescind for breach of contract for underwriting errors ; and,
- (13) Provides for binding arbitration to settle breach of contract disputes.

(3) Prudent Underwriting of Mortgage Insurance Risk

The provision of PMI must be managed with an appropriate focus on risk management and sound credit quality. QPMIs should evidence prudent underwriting of mortgage insurance risk resulting in a risk profile of the PMI provider that is highly correlated to the default risk of the type of post-crisis single-family mortgages held on-balance sheet by banks or securitized through the GSEs.

A PMI provider insuring material amounts of higher risk loans, such as loans not meeting the characteristics of Category 1 loans as defined in the *Standardized Approach*, may not be operating in a safe and sound manner. In addition, because the predominant insured business of PMI providers is low-down payment lending, the insured portfolio of a PMI provider should not have excessive concentrations of layered risk attributes. For example, very low down payments of less than 5%, weak credit histories (e.g., FICO<660), and investor financing should be limited. Other layered risk attributes that were highly problematic in the recent crisis, such as negative amortization and “no doc” lending, are not noted because they are unlikely to be evident in the broader lending market due to regulatory constraints.

We recommend that banks monitor the risk profile of newly insured loans as an indicator of the PMI provider’s approach to prudent mortgage insurance risk underwriting. PMI providers should make available to banks sufficiently detailed reporting on the composition of new insurance written for the most recent four quarters to enable banks to conduct due diligence reviews on the credit quality of new business. This information should allow banks to monitor credit quality trends in newly insured business on an absolute basis and across PMI providers.

Conclusion

In requesting comment on how coverage from financially-sound PMI providers could be recognized, the Agencies acknowledge that financially sound PMI providers can serve as reliable credit risk mitigation for banks.

As a voice for new private capital in the PMI market, Essent’s perspective is forward-looking and we have offered a prudential framework with criteria under which well-capitalized PMI

providers doing business with a sound contract and underwriting prudent risk can be identified by banks and designated as a QPMI eligible for capital recognition.

The adoption of the framework and sound prudential standards we propose would create an overlay of federal requirements for PMI providers that wish recognition in bank capital rules, in addition to the regulatory requirements already applicable to PMI providers. If adopted, such standards create strong incentives for PMI providers to meet and retain QPMI status, given the significant role banks play now and will play in the future of housing finance. The continued recognition of PMI based on prudential federal standards would also encourage and facilitate further private capital investment in the PMI sector, helping restore for banks a competitive PMI industry providing a valuable, time-tested tool for risk and capital management.

In sum, recognition of QPMI would be beneficial to banks and the housing finance system because it would:

- Maintain banks' long-standing option to use PMI for capital management and diversification of mortgage credit risk, thereby preserving banks' flexibility to either hold insured loans on balance sheet or access liquidity by transferring risk to the secondary market through securitization;
- Facilitate the flow of affordable low-down payment lending by banks, which is demonstrably needed in the years ahead because of the loss of home equity from the decline in home prices;⁹
- Support housing demand, which is needed to absorb the significant over-supply of housing coming to market in the years ahead and thereby help sustain the housing recovery; and
- Increase the role of purely private capital bearing mortgage credit risk in the U.S. housing finance system and reduce reliance on taxpayer risk-bearing through government mortgage insurance programs such as FHA and VA. While government-backed loans merit a greater reduction in bank capital requirements due to their sovereign full faith and credit backstop, granting PMI no credit – even with respect to QPMIs – will exacerbate the problem of excessive taxpayer risk-bearing in the mortgage market.

We appreciate the consideration of our comments by the Agencies and would be pleased to answer any questions or provide any additional supporting information that might be useful to finalization of the capital rules.

Very truly yours,



Adolfo F. Marzol
Vice Chairman

Schedule A: Stress Test Illustration

For purposes of illustrating the stress test methodology proposed herein, assume a simple example as follows:

- A PMI provider has insured a 90% LTV, 700 FICO single-family residential mortgage meeting the criteria for Category 1 loans as defined in the *Standardized Approach*.
- The loan has an original principal balance of \$200,000 insured with 25% mortgage insurance coverage.
 - *Note: the PMI provider's risk-in-force is \$50,000 (\$200,000 loan balance x 25% coverage) and the effective LTV on the loan net of the insurance coverage is 67.5% (90% LTV minus 90% x 25% coverage).*
- The premium rate for the insurance coverage is .60% (per annum of the loan balance).
- The loan has a 4.5 year average life.
 - *Note: In some instances PMI providers collect their entire premium upfront in a single non-refundable payment. In such instances, no assumption needs to be made about the average life of the loan, as the life-of-loan earned premium is known with certainty once collected. However, a monthly premium may be more affordable than a lump sum upfront premium, and monthly premium plans remain the predominant market choice.*

The stress test assessment begins with defining under conditions of severe economic stress the probability of default ("PD") of the mortgage loan. We assume for this example that under conditions of severe economic stress and declining home prices this loan has an expected PD of 14%. We assume further that the insurance coverage, on average, experiences an LGD of 100%.

The stress test for this loan would be calculated as follows:

- **Stress Losses = \$7,000** (\$50,000 risk-in-force x 14% PD x 100% LGD)
- **Projected Net Earned Premium Income = \$4,320** (\$200,000 loan balance x .60% premium rate x 4.5 yr avg. life x 80% (to adjust for 20% of premiums to cover operating expenses)
- **Required Capital = \$2,680** (\$7,000 of Stress Losses – \$4,320 of Projected Net Earned Premium Income)

In this example, required claims paying resources total 14% of the PMI provider's insured exposure (\$7,000 stress loss ÷ \$50,000 exposure) and required capital for QPMI status would be no less than 5.4% of the MI providers risk-in-force (\$2,680 required capital ÷ \$50,000 risk-in-force).

In addition to premium income, PMI providers earn investment income on their capital. However, for purposes of simplification, no investment income has been included in this illustration.

Schedule B: Essent's Clarity of Coverage®

Summary of key features of Essent's Master Policy including *Clarity of Coverage*;¹⁰ Essent will:

- Not rescind coverage for immaterial underwriting errors or misrepresentations.
- Not rescind coverage, for delegated lenders¹, for underwriting errors or non-compliance when the borrower has made 36 months of timely payments unless there has been a misrepresentation of certain key factors which would have rendered the loan ineligible for Essent coverage.
- Not rescind coverage for non-delegated lenders², if we make an underwriting error during our MI underwrite.
- Not rescind coverage for overstated appraised values unless a review appraisal shows at least a 15% overstatement of value when the loan was made, and there is evidence showing the appraiser acted improperly.
- Not assume, without credible evidence, that a lender or its representative was involved in a borrower's fraud.
- Not rescind coverage when a document that wasn't material to the loan's eligibility or risk assessment is missing from the file.

Essent generally considers misrepresentations to be material if, had the true facts been known, the Loan would not have been eligible for coverage at the time of origination.

¹ Delegated lenders are lenders to whom Essent has delegated its underwriting authority . As such, delegated loans are not directly underwritten by Essent prior to closing but are subject to underwriting representations and warranties and are monitored through quality assurance procedures.

² Non-delegated lenders must submit loans to Essent for underwriting and approval prior to the loan being insured by Essent.

Endnotes

¹ *Standardized Approach NPR* Sec. F. Credit Risk Mitigation “Banking organizations use a number of techniques to mitigate credit risks. For example, a banking organization may collateralize exposures with first-priority claims, cash or securities; a third party may guarantee a loan exposure; a banking organization may buy a credit derivative to offset an exposure's credit risk; or a banking organization may net exposures with a counterparty under a netting agreement. The general risk-based capital rules recognize these techniques to some extent. This section describes how a banking organization would recognize the risk-mitigation effects of guarantees, credit derivatives, and collateral for risk-based capital purposes under the proposal.”

² Three PMI providers (Triad, PMI and RMIC) are currently in “runoff” meaning that they are not permitted to write new business until they increase capital in relation to risk-in-force to a satisfactory level. Companies in runoff are paying a minimum of 50% of their claims in cash, and none of these companies have been deemed insolvent by their state of domicile insurance regulator.

³ *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 77 Fed. Reg. 35253, 35254 (June 13, 2012).

⁴ For MI companies, insured loans that are delinquent require GAAP loan loss reserves for their expected losses and are deducted from capital. As such, we simplify the proposed stress test to exclude delinquent loans and the related loan loss reserves. Alternatively, the exposure on insured delinquent loans could be included in the stress test estimate of future claim losses and the related loan loss reserves on such delinquent loans could be added to the claims paying resources.

⁵ The stress test we propose addresses a PMI provider's off-balance sheet insurance exposure. In addition, an appropriate capital charge would also be established for a PMI provider's on-balance sheet assets.

⁶ Capital of 5%-6% of insured risk-in-force is equivalent to risk-to-capital (“RTC”) ratios of 20:1 to 16:1, are a more customarily utilized capital metric in the PMI industry (see endnote 7). Essent's analysis is for loans insured with primary mortgage insurance, with average coverage levels in the range of 20-25%, as is customary in the market. Use of the 5%-6% range may not be appropriate for pool insurance, although pool insurance has not been actively used in the market on loans originated in 2009 and later.

⁷ State insurance law requires adequate claims-paying resources by setting either a RTC ratio (as in New York and North Carolina for example) or minimum policyholder position (as in Arizona and Wisconsin, as examples) standard. The RTC approach measures the ratio of the company's risk-in-force to its capital. Typically, this ratio may not exceed 25:1. The inverse of the 25:1 RTC ratio, which is the ratio of capital to risk-in-force, is 4%.

⁸ Listed requirements (1)-(8) for PMI contracts are drawn from the standards the Agencies have proposed for *eligible guarantees* to be recognized for credit risk mitigation purposes. See the definition of *eligible guarantee* in *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Rules, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (“Basel III NPR”)*, 77 FR 52792 (August 30, 2012). Criteria (9)-(13) were added by Essent to further strengthen the required contractual terms for bank policyholders.

⁹ The Agencies should be aware that policy actions that needlessly drive borrowers into FHA loans could result in many low-down payment borrowers being served at potentially much higher costs. For example, a 90% LTV borrower with a FICO score of 700 and meeting Essent's other credit criteria for insurance eligibility would be charged a borrower-paid MI premium of .62% per annum. The same borrower would be required to pay FHA insurance premiums of 1.75% upfront and 1.20% per annum, which combine to be an annual effective premium rate for the FHA insurance of 1.59% (assuming a 4.5 year average life for the loan).

¹⁰ The specific terms are in the full *Clarity of Coverage* endorsements, which are posted on our website at www.essent.us.