Mortgage Insurance Companies of America

January 14, 2013

Secretariat to the Financial Stability Board
Bank for International Settlements
CH-4002 Basel, Switzerland

RE: A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Consultative Document

Dear Sir or Madam:

The Mortgage Insurance Companies of America ("MICA") is pleased hereby to comment on the Financial Stability Board ("FSB") consultative document on strengthening oversight and regulation of shadow banking.[1] MICA represents the interests of U.S. providers of private mortgage insurance ("Private MI") and thus has a keen interest in the proposed new regulatory framework, which is why MICA participated in the FSB's initial fact-finding efforts and broadly supports the policy framework outlined in the consultative document. Mortgage insurance facilitates credit creation by promoting prudent low down payment lending but does not increase systemic risk or invite regulatory arbitrage. The recent global housing market downturn has led to questions, some posed by the FSB, about the adequacy of the insurance regulatory model to govern Private MI, and our comment letter will address many of those questions

Furthermore, while the industry certainly was affected by the unprecedented housing market downturn, as we discuss below, the model did not fail. MI did not trigger any "runs" on other institutions, nor did it lead to any systemic "contagion." Simply put, there is no evidence to suggest that MI amplified systemic risk, which we understand is the primary concern raised in connection with the shadow banking system. We thus respectfully urge the FSB to defer to the current structure of Private MI regulation in the United States, to ensure that borrowers and financial institutions can continue to rely on an essential source of third-party capital put at risk to promote sound mortgage finance.

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[1] FSB, *A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* (Nov. 18, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121118a.pdf.

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In this letter, we first provide you with updated information on the condition of Private MI in the United States. Importantly, Private MI has provided vital private capital to reduce the cost to U.S. taxpayers of the recent mortgage crisis. For example, Private MI firms have to date paid or are committed to pay $33.5 billion to cover losses on mortgages held by the government-sponsored enterprises ("GSEs"), materially reducing taxpayer costs since the GSEs were placed into conservatorship and facilitating the GSEs' essential role in U.S. housing finance.[2] Private MI has also reduced losses to portfolio lenders that purchase MI and to the Federal Deposit Insurance Corporation ("FDIC") because the FDIC is able to recover from Private MIs some of its losses on defaulted mortgages held by failed banks, although data on this are not available. After providing an update on the U.S. industry, we will proceed to address the "toolkit" detailed by the FSB, providing our assessment of these key criteria and the manner in which the current and evolving regulatory framework achieves the FSB's stated goals.

Key MICA recommendations include:

- The FSB should defer to existing regulation in the United States, especially in light of work that is underway to review and reassess that regulation. Work is being conducted by federal banking agencies, housing regulators and state insurance regulators. Indeed, the willingness of the National Association of Insurance Commissioners ("NAIC") to establish a working group on Private MI evinces intent to ensure that Private MI regulation appropriately reflects the full scope of prudential concerns. NAIC's encouragement of information-sharing, whether through existing state insurance law or regulatory provisions, or via its Risk Management and Own Risk and Solvency Assessment Model Act (together with the implementing manual, "ORSA") demonstrates strong support for a coordinated and systematic effort to monitor and control any risks identified in the private MI sector during the crisis. Deferral for now to this U.S. regulatory rewrite would permit the FSB to assess the degree to which the insurance-regulatory framework now applied to MI meets its concerns, thus avoiding creation of an unnecessary level of global regulation that may not recognize proven experience in the

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[2] Fannie Mae, 10-K Annual Report (2008, 2009, 2010, 2011), 10-Q Report (Q3 2012), *available at* http://www.fanniemae.com/portal/about-us/investor-relations/quarterly-annual-results.html and Freddie Mac, 10-K Annual Report (2008, 2010, 2011) and 10-Q Report (Q3 2012), *available at* http://www.freddiemac.com/investors/reports.html.

world's largest Private MI market and/or create the potential for regulatory arbitrage. Deferring action would also enhance the quality of any final FSB recommendations, as these will be informed by the comment period and analytics underlying U.S. action. To assist the FSB, we herein provide comments on each of the FSB's proposed "tools," noting the manner in which these now apply in the U.S. and the manner in which they performed under the acute stress of the recent crisis.

- MICA strongly endorses the FSB's focus on the need for counter-cyclical capital for providers of mortgage insurance. We herein describe features of the Private MI regulatory-capital framework in the U.S. that is, we submit, a unique counter-cyclical one unmatched to date in the bank capital framework or other regulatory standards. While the crisis revealed the need to reevaluate Private MI regulation, the capital framework was stressed largely because Private MIs paid unprecedented amounts of claims in the face of the housing downturn.

- MICA strongly endorses "Tool 5" – that is, the need for risk-sharing. We here detail how this is now done in U.S. Private MI, which, as the FSB rightly notes, provides first-loss coverage rather than unlimited credit insurance, which can alter incentives for mortgage originators and investors.[3]

I. Current Private MI Framework

In the United States, Private MI principally provides insurance on the credit risk borne by lenders and/or investors related to residential mortgages with loan-to-value ("LTV") ratios above eighty percent. U.S. private mortgage insurers have $712.9 billion of insurance-in-force[4] covering mortgages held by banks in portfolio and loans included in mortgage-backed securities ("MBS") issued by the GSEs and private securitizers. In its recent statement on global mortgage-underwriting standards,[5] the FSB has recognized the role of Private MI,

[3] In the U.S. and other markets, Private MI is not structured to cover all losses, which means that mortgage investors have ongoing exposure in the event of mortgage defaults. Even in jurisdictions where MI coverage is designed to cover 100% of losses, lenders have strong regulatory (and reputational) incentives that fundamentally align their interests with those of the MI.

[4] Inside Mortgage Finance, Insurance-in-force for all U.S. MI firms as of the end of Q3 2012 (Nov. 16, 2012), page 4.

[5] FSB, *Principles for Sound Mortgage Underwriting* (Apr. 18, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120418.pdf.

noting that it is "a way to provide additional financing flexibility for lenders and borrowers."[6] This consultative paper also correctly observes that mortgage insurance "can play an important role in providing an additional layer of scrutiny on bank and mortgage company lending decision"[7] as long as the Private MI is properly regulated. The credit-risk mitigation ("CRM") value of Private MI is also reflected in the risk-based capital standards issued by the Basel Committee on Banking Supervision ("Basel Committee"), which have historically included Private MI as a risk mitigant reflected in the risk weightings that define prudent mortgages for purposes of reducing risk weights in the standardized model and as a recognized form of CRM in the advanced internal rating-based approach.[8]

In the United States, Private MI is regulated by the states consistent with the overall U.S. framework of insurance regulation. However, the GSE charters[9] include an express requirement that the GSEs use insurance or other forms of stipulated CRM when they purchase mortgages with LTVs above eighty percent. Reflecting this charter recognition, the Federal Housing Finance Agency ("FHFA") that governs the GSEs also scrutinizes U.S. Private MIs to ensure that they are able to honor claims. This creates an overlay of federal review that supplements state insurance regulation; any Private MI not deemed "eligible" to provide coverage to the GSEs would face serious obstacles doing business with banking organizations or other entities.

The state insurance regulatory regime has numerous unusual and robust provisions. For example, it is perhaps unique among any regulatory framework by long including a counter-cyclical capital requirement. U.S. Private MIs are required by the states in which they do business to hold back half of each premium dollar in a catastrophic-risk reserve for ten years to promote claims-paying capability under stress. To be sure, the mortgage crisis has put significant strain on U.S. Private MI firms, and several MIs are currently in "run-off" – that is, orderly resolution. Even so, however, other Private MIs have withstood the U.S. crisis and MI has not in any way caused overall systemic instability. The industry benefits not only from stringent capital and reserve requirements, but also from regulatory prohibitions on taking correlated risk – that is, they may not invest in assets that pose risks comparable to those they ensure, preventing the type of risk

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[6] *Id.* at page 7.
[7] FSB, *A Policy Framework for Shadow Banking Entities,* see page 9.
[8] Basel Committee, *Basel III: a global regulatory framework for more resilient banks and banking systems* (Dec. 2010), *available at* http://www.bis.org/publ/bcbs189.pdf.
[9] Federal National Mortgage Association Charter Act, 12 U.S.C. 1717 § 302(b)(2)(C); Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1454 § 305(a)(2)(C).

correlation that proved so damaging to monoline bond insurers during the financial crisis.

The industry, like all other participants in the housing finance market, is undergoing a serious assessment of "lessons learned" from the crisis, and is committed to enhancing the model to make it even stronger going forward. Reflecting this, MICA members are committed to working with regulators to refine the current state-regulatory model. We have, for example, provided detailed comments to the U.S. banking agencies on the way to define "sound" MIs for purposes of recognizing risk mitigation in the U.S. version of the Basel III capital rules.[10] MICA's complete comment to the U.S. banking regulators on implementation of the Basel III rules is attached to this comment letter with associated appendices.

As noted in the MICA comment letter, the U.S. banking regulators benefit from insurance regulatory efforts to improve prospective measures of insurer solvency. The recent adoption by the NAIC of the Risk Management and Own Risk and Solvency Assessment Model Act (together with the implementing manual, ORSA) underscores the commitment of U.S. insurance regulators to increased scrutiny of insurer enterprise risk management and capital sufficiency.[11] ORSA will apply to Private MI providers. For purposes of counterparty risk assessment, ORSA strengthens existing substantive standards and enhances a process through which greater coordination between federal and state financial sector regulators might be accomplished.

MICA respectfully submits that MI regulation is sufficient and effective, and that additional oversight would only limit the industry's

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[10] MICA, comment letter on Interagency Proposal, *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52888 (Aug. 30, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/November/20121115/R-1442/R-1442_102212_110494_384404962055_1.pdf.

[11] ORSA Model Act, *available at* http://www.naic.org/documents/committees_e_risk_management_orsa_adopted_120906.pdf, and the accompanying ORSA manual, *available at* http://www.naic.org/documents/committees_ex_isftf_group_solvncy_exposure_draft_orsa_guidance.pdf. ORSA is not a legal requirement until January 2015, but state financial examiners already are being trained as part of the implementation process. Insurers are being advised to begin preparations. *See, e.g.,* Deloitte Forward Focus, "The Own Risk and Solvency Assessment: A regulatory guidepost to the future" at 5 (Fall 2012), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_ForwardFocusORSA_092112.pdf; Tom Sullivan, "What Does NAIC's Adoption of RMORSA Mean?" PropertyCasualty 360 (Sept, 14, 2012), *available at* http://www.propertycasualty360.com/2012/09/14/what-does-naics-adoption-of-rmorsa-model-act-mean?t=regulation-legislation.

ability to play its important roles of providing CRM and scrutiny of bank lending policies and practices. We thus urge that FSB work in concert with these efforts and not seek to supersede them as it establishes a global framework for credit insurance. Because the United States has the most established MI industry and the greatest market reliance on it, the final U.S. framework for MI should create a robust platform that aids the FSB in establishing a cross-border, harmonized framework that ensures prudent credit insurance without the prospect of regulatory arbitrage.

II. "Toolkit"

In this section of our letter, MICA is pleased to comment on the tools outlined in Section 3.2.4 of the consultative paper. We here provide basic principles on each of the tools to guide FSB thinking. As further discussed below, MICA believes that current regulatory regimes largely contemplate the tools discussed by the FSB and we again urge the Board to defer a specific Private MI regulatory framework until final decisions are made in the United States by the federal banking agencies, state insurance regulators and, should it choose to weigh in, the FHFA.

A. Tool 1: Capital

As noted, MICA has engaged with the U.S. banking agencies in response to the question about the criteria that should differentiate "sound" Private MIs and thus provide for recognition in terms of reduced risk weightings in the U.S. version of the Basel III rules. In these comments, we made clear that we concur with the FSB's focus on preventing a Private MI capital framework that is procyclical, strongly supporting continued reliance on the catastrophic reserve described above in concert with possible enhancements to the Private MI regulatory-capital model. FSB has urged in this consultative paper that capital reserves be held for a sufficient period of time to prevent procyclicality and we draw the FSB's attention to the ten-year requirement now embodied in the U.S. framework for private mortgage insurance. As noted above, this requires reserving half of each premium dollar in a catastrophic reserve for ten years to ensure claims-paying capacity under stress. Importantly, this catastrophic requirement does not obviate the need for Private MIs in the U.S. also to hold specific reserves for loans subject to claims payment, with state regulators and auditors regularly reviewing this and a "premium-deficiency" reserve to bolster claims-paying capacity. We know of no other regulatory-capital framework analogous to this requirement, which goes well beyond the "expected" loan-loss reserve framework now under consideration by the Financial Accounting Standards Board

("FASB")[12] and the International Accounting Standards Board ("IASB").[13] It is also considerably more robust than the Basel III framework for banking organizations providing financial guarantees[14] which, despite the capital-conservation buffer and some increased attention to stress testing in "Pillar 2," continues to base capital requirements on quarter-by-quarter risk assumptions that continue the capital framework's potential procyclical effect.

B. Tool 2: Restriction on Scale and Scope

MICA submits that the current state regulatory framework for MI meets the objectives outlined in this tool. In sharp contrast to nonbanks that seek to provide credit insurance through guarantees or similar structures, MI cannot be offered without prior approval of a state insurance regulator for the creation of a company offering this service. The ORSA enhances this framework, creating a meaningful barrier to entry to any provider that does not have sufficient capital or meet other prudential requirements. This barrier to entry is further enhanced by the "eligibility requirements demanded by the GSEs pursuant to FHFA supervision, with these standards dictating numerous criteria (including a size sufficient to honor claims on an ongoing basis).

C. Tool 3: Liquidity Buffers

As the FSB notes, insurance companies generally do not face the same short-term liquidity stresses observed in the banking sector during the financial crisis. We concur that MIs need liquidity buffers sufficient to ensure claims-paying capacity under stress. The FSB does not, however, provide any specific proposals for liquidity buffers in this sector nor indicate the degree to which it fears that the current U.S. framework is problematic. Absent additional work in this sector by the FSB that is then released for public comment, MICA urges the FSB to focus its action on capital standards and the broader risk-management framework outlined in this consultative document.

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[12] FASB, *Proposed Accounting Standards Update: Financial Instruments–Credit Losses* (Dec. 20, 2012), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175825477164&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.
[13] IASB, *Statement on meeting to review ongoing projects and other topics* (Jul. 18, 2012), *available at* http://www.ifrs.org/Alerts/PressRelease/Documents/PRIASBEFRAGJuly2012.pdf.
[14] Basel Committee, *Basel III framework.*

D. Tool 4: Enhanced Risk Management Practices to Capture Tail Events

MICA concurs with the FSB that providers of credit insurance should conduct risk modeling and, as needed, stress testing to ensure claims-paying capacity even under severely-adverse scenarios. Insurance regulators routinely review each MI's risk-modeling and subject mortgage insurers to robust, dynamic stress testing. In addition, the GSEs conduct their own stress testing, and thoroughly review MI company models. MICA urges the FSB to work with state insurance regulators to determine the nature of these modeling standards in the U.S. arena before proceeding to specify any standards that may prove inappropriate here or fail to take U.S. experience into account in other national regimes.

E. Tool 5: Mandatory Risk Sharing

MICA strongly endorses the FSB's tool for proper credit-insurance regulation that emphasizes risk-sharing between the insured party and the Private MI provider. However, we note that there are many ways to systemically align incentives, and that while direct "risk-sharing" is one such tool, regulation around mortgage lending and mortgage servicing practices and standards can also serve this role and do so in other jurisdictions. In the United States, we would note that one reason for the severe losses recently experienced by the FHA is that it covers 100 percent of a mortgage, providing reduced incentives for the originator or servicer of the loan to ensure that a mortgage is prudent and in full compliance with FHA standards prior to stamping the mortgage with a full-faith-and-credit USG guarantee. As the FSB correctly notes, Private MI is a first-loss form of credit insurance. It thus limits the "severity" of claims – i.e., the loss given default ("LGD") – based on the agreement between the Private MI and the insured party as to the depth of coverage.

Private MI in the U.S. also has the contractual power to submit deficient mortgages back to the originator or servicer (i.e., to engage in rescission) when the MI determines upon submission of a claim that the originator failed to comply with stipulated underwriting terms and conditions, engaged in fraud or otherwise did not honor its contractual obligations. This risk-share construct is analogous to the many similar arrangements in property-and-casualty insurance that, for example, do not require an insurer to honor a claim for fire damage when the insured party engages in arson. Without rescission, risk-sharing incentives in the mortgage-insurance arena would not appropriately ensure that the originator's incentives are aligned with those of the mortgage insurer.

Critically, incentive alignment between the lender and the Private MI is also vital to the mortgage borrower, as it creates a strong incentive for the lender to ensure the borrower's long-term ability to repay. Without this, the lender may not care if the borrower enters foreclosure because it expects the Private MI to pay a claim – a risk also analogous to the arson example noted above.

Conclusion

MICA strongly supports the FSB's goals as detailed in this framework: the creation of a regulatory framework for providers of private mortgage insurance that promotes stable, long-term mortgage finance in a manner that protects all parties in the financial market without creating procyclical incentives that pose macroeconomic risk. As discussed above and as noted in the comment letter to U.S. bank regulators attached hereto, we are actively engaged with U.S. policy-makers to ensure that the framework here meets these objectives, building on the state-insurance regulatory framework that is, we believe, already consistent with the tools outlined by the FSB in this consultative document. We would be honored to work further with the FSB to answer any questions you may have about Private MI regulation or support any additional work the FSB determines to undertake in this sector.

Sincerely,

Susan Ironfield
Acting Executive Director