rrc risk & regulatory CONSULTING

Via E-mail: adaleo@naic.org

March 29, 2013

Commissioner Ted Nickel, Chair
Mortgage Guaranty Insurance (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street
Kansas City, MO 64106-2197
C/o Andy Daleo
Property/Casualty Financial Analysis Manager

Dear Mr. Nickel:

Risk & Regulatory Consulting, LLC (RRC) is pleased to provide comments to the Concepts-List of Potential Regulatory Changes issued February 19, 2013 by the Mortgage Guaranty Insurance (E) Working Group. We agree that the NAIC can help provide additional protection to consumers by working to establish additional solvency safeguards that are uniform across the states. We ask the Working Group to consider the comments noted below in relation to any reform of the NAIC's Mortgage Guaranty Insurance Model Act. Key contributors to this comment letter were Barbara Bartlett, Wayne Johnson, Patrick Tracy, Michael Dubin, Jared Rubinstein and Marg Spencer.

Required minimum underwriting standards

a. RRC agrees with the Working Group's proposal regarding minimum underwriting standards. We also support requiring approval by the Commissioner of the mortgage insurance underwriting standards, and approval of any changes to those underwriting standards made as a result of new requirements established by government servicing entities (GSEs).

   We support the Dodd-Frank Act requirement that the loan originator retain <u>at least</u> five percent (5%) of the credit risk to prevent transaction driven sales activity on the part of the loan originator. The retention of the risk by the loan originator should apply to <u>all</u> transactions applicable to a loan and preclude any subsequent transactions with other parties which would leave the loan originator with less than 5% of the credit risk. The originators should also be required to certify that they are meeting both the mortgage insurer's underwriting standards and their own standards in addition to any guidance provided by the GSEs.

b. We agree that allowing potential borrowers to seek out their own mortgage insurer, for loans with less than a 20% down payment would help to eliminate the hold lenders have over the mortgage insurers. This would also allow mortgage insurers to ensure their underwriting standards are followed and be able to price the risk reasonably.
c. RRC has assisted with the review of several mortgage guaranty insurers. Our analysis suggests that the proposed geographic concentration limitation would be more effective if set at a threshold lower than 50% in any one state.
d. We do not think changing the coverage limitation addresses the issues that mortgage insurers faced during the recent economic downturn. Those issues were predominantly related to underwriting standards that allowed insurance on loans with little to no documentation and that were high-risk loans. Requiring stronger internal controls to ensure underwriting standards are followed by all parties involved would reduce future risk.

Consider changes to minimum capital requirements
RRC agrees the mortgage insurance companies need to have sufficient capital to meet needs during severe economic downturns. However, requiring paid-in capital of $10 million and paid-in surplus of $25 million for stock companies and $25 million for mutual companies does not appear sufficient in light of the billions of dollars in premiums collected and losses paid and yet to be paid by mortgage insurers. RRC would suggest the minimum capital be a function of the actual risk and take into consideration any contingency reserve requirements. Making minimum capital a function of the company’s exposure to risk seems more relevant, i.e. the higher the risk exposure the higher the minimum capital requirement, the lower the risk exposure, the lower the requirement. We believe that a review of the financial results of the mortgage guaranty insurance companies ordered into receivership since 2009, along with those currently in supervision may provide valuable data that will assist the Working Group in setting a standard for minimum capital requirements.

Since many mortgage guaranty insurers tend to transact business on a national basis, one element of this strategy should be to set a uniform standard for risk in relation to the capital requirement. It also seems evident that it would be helpful to regulators and provide better protection to the potential claimants to more clearly define a more uniform regulatory response to any company that is unable to meet the capital requirements.

Update and modify contingency reserve requirements
RRC believes that an update to the contingency reserve requirements is appropriate. Mortgage guaranty insurance contingency reserves are formula driven and, by their nature, do not take into account the actual risk of a company.

In conjunction with a review of the contingency reserve requirements, the accounting practices should more clearly address the issue of reserving for rescissions and denials on appeal. Our experience has been that mortgage guaranty insurers remove reserves for these policies once they rescind or declare a denial. If rescinded or denied policies are in appeal, the insurance company should be required to reserve for these policies until the appeal is finalized, as they are contingent liabilities that are known and the amounts clearly estimable.

Abolish reinsurance requirements and prohibit captive reinsurance arrangements
RRC agrees there needs to be a thorough review of the reinsurance practices of mortgage guaranty insurers. The number of mortgage guaranty reinsurers is very small and as such, there is very little spreading of the ultimate risk. In many cases, the reinsurer tends to be another member of the same holding company group. A concentration of the risk with reinsurers within a holding company group increases the potential for an insolvency. RRC agrees that a more effective arrangement may be to have either a mutual reinsurance company that all mortgage insurers can use to house additional reserves for economic downturns or an entity that serves as a backstop, equivalent to the FDIC, where premiums are paid in over a business cycle and retained for periods of deep recession.

Many mortgage guaranty insurers and lenders have been named as defendants in lawsuits in conjunction with captive reinsurance transactions. This matter may be settled in Court without any action on the part of the NAIC; however, there are solvency aspects relating to the use of captives that should be considered by the Working Group. In at least some of the captive insurer arrangements, the ability of the mortgage guaranty insurer to recover funds owed to it in excess of the amount held in trust may be limited, further causing solvency concerns.

Revisit statutory accounting practices in SSAP No. 58 and Appendix A-630
RRC recommends revisiting statutory accounting practices related to mortgage insurers. Additional scrutiny should be given to reserving practices and a more comprehensive approach to mortgage guaranty insurance reserves. In addition, premium recognition as well as the methodology used for the establishing premium deficiency reserves should be revisited.

Reserving practices – As stated in SSAP No. 58, when a loan has been delinquent two or four months, the mortgage insurance policy requires the lender to notify the insurer. Further, the lender may have agreed to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months to complete the process, which could mean a considerable delay between the delinquency and the date of the claim. Thus, due to the lengthy lag time, claims may not be recognized timely in the financial statements. In practice, delinquent loans of which the insurer has knowledge, possibly for an extended period of time, are probable of becoming a claim and where the liability can be estimated, may not be established in reserves for well over a year. This approach appears to be contrary to accrual accounting and contingent loss recognition statutory accounting policies. Loss recognition accruals or reserves should be established on a more immediate or timely basis given knowledge of delinquencies and the ability to estimate (either individually or in the aggregate) the loss amount and the probability of a loss occurring.

Premium accounting - mortgage premiums stem primarily from monthly installment premiums. Mortgage insurers expect premium income to continue long after the last contract is written; however, this future premium income may not be recognized in current financial statements fully or to the same extent as with other types of property-casualty insurers.

Premium deficiency reserves – the current guidance as to how premium deficiency reserves (PDR) should be determined for a mortgage insurer is less clear than with other property-casualty insurers. RRC suggests that the guidance be expanded and the methodology used by mortgage insurers refined. Other property-casualty insurers are required to establish PDRs based upon grouping the policies in a manner consistent with how policies are marketed, serviced and measured. A liability is recognized for each grouping where a premium deficiency is indicated. Deficiencies cannot be offset by anticipated profits in other policy groupings. In practice, mortgage insurers may aggregate all policies when assessing the need for a PDR. Thus, a premium deficiency in a particular state or group of policies may not be apparent because of the aggregation of the premium deficiency results for all policies.

Compared with other lines of insurance, the above points can potentially mask the recognition of results in the current financial statements. Premium recognition may not be appropriately matched to risk exposure. While a premium deficiency reserve may mitigate this issue to some extent, recent history in the mortgage insurance industry has shown it not to be completely effective for this purpose. Therefore, financial statements alone have limited usefulness in gauging the financial health of mortgage insurers. The recent severe economic downturn generated results not contemplated in current accounting policies and therefore created the need to revisit the statutory accounting guidance.

In conclusion, we believe it is important that all stakeholders be involved in these discussions and that the Working Group come to well-reasoned decisions. The approval of low documentation and no documentation loan standards by the parties involved in the mortgage industry created a sales environment where lenders failed to focus their attention on prudent underwriting standards in order to have more loans packaged and sold. Compared to the banking industry, the insurance industry demonstrated solid results without a significant spike in insurer failures due to well-considered and diligent regulation. However, the severity of the most recent economic downturn placed significant undue pressure on already resource-constrained state insurance regulators to address the mortgage insurer solvency concerns in their respective states. We applaud their continued diligent efforts.

Sincerely,
Risk & Regulatory Consulting, LLC.

Wayne Johnson

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