AMERICAN ACADEMY *of* ACTUARIES

May 1, 2013

Via email to baselcommittee@bis.org

Secretariat of the Joint Forum (BCBS Secretariat)
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: *Bank for International Settlements Consultative Document on Mortgage insurance: market structure, underwriting cycle and policy implications*

The American Academy of Actuaries[1] Casualty Practice Council (CPC) appreciates the thoughtful recommendations outlined in the Bank for International Settlement's (BIS) Consultative Document, *Mortgage insurance: market structure, underwriting cycle and policy implications*, and generally agrees with most of the specific suggestions for policymakers and supervisors.

We have organized our responses to the specific recommendations into the following general categories:

- Underwriting Recommendations: Responses to recommendations dealing with the prudent origination and underwriting of mortgages and mortgage insurance (i.e., report recommendations 1, 2, 3, and 6); and

- Capital and Safety and Soundness Recommendations: Responses to those recommendations dealing with capitalization and prudent accounting provisions (i.e., report recommendations 4 and 5).

Underwriting Recommendations

Recommendations 1, 2, 3, and 6 from the consultative document's recommendations for policymakers and supervisors relate to the loan origination process and prudent underwriting standards:

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

1. **Policymakers should consider requiring that mortgage originators and mortgage insurers align their interests.**
2. **Supervisors should ensure that mortgage insurers and mortgage originators maintain strong underwriting standards.**
3. **Supervisors should be alert to – and correct for – deterioration in underwriting standards stemming from behavioural incentives influencing mortgage originators and mortgage insurers.**
6. **Supervisors should apply the FSB Principles for Sound Residential Mortgage Underwriting Practices to mortgage insurers noting that proper supervisory implementation necessitates both insurance and banking enterprise.**

We generally agree with and support recommendations 1, 2, 3, and 6 proposed in the report and set forth above, which aim to utilize the regulatory and supervisory role to ensure that the underwriting quality of loans originated and insured maintain strong underwriting standards. Those that retain the majority of the risk should take the greatest responsibility in maintaining strong underwriting standards. The CPC believes that risk sharing will place that responsibility and financial burden on both parties. Strong enterprise risk management (ERM) by banks and insurers can ensure that strong underwriting standards are maintained in all cases, while regulators and supervisors can use their authority to monitor insurers' and banks' efforts to maintain proper underwriting standards.

We support the report's recommendation that the interests of mortgage originators and insurers be aligned. We also support the recommendation that supervisors be alert to and may facilitate the correction of a significant deterioration in underwriting standards for the industry. We agree that the Financial Stability Board (FSB) Principles for Sound Residential Mortgage Underwriting Practices outline a strong framework for mortgage underwriting that could be adapted for use in the mortgage insurance industry.

Our comments on each of the specific underwriting recommendations are outlined below.

Recommendation 1: aligning the interests of mortgage originators and mortgage insurers

Mortgage originators and insurers can align their interests in multiple ways, ranging from risk retention mechanisms to long-term rating plans between mortgage originators and insurers. Banking and insurance supervisors could collaborate to provide consistency in aligning the interests of mortgage originators and insurers.

Private mortgage insurers typically assume a "first-loss" position when issuing an insurance policy. This means that the mortgage insurer will pay a claim up to the coverage limits of the policy, typically the first 10 percent to 30 percent of the outstanding balance, and the investor in the mortgage will absorb any additional loss amount beyond the mortgage insurance coverage limits. In a two-party transaction between the mortgage originator/lender and mortgage insurer, where the originator remains the investor in the mortgage, the interests between the two parties may be partially aligned, depending on the severity of the loss, as each may incur a financial loss as a result of a default, depending on the severity of the loss, though the extent of this alignment could be strengthened through pro-rata co-participation in losses, as discussed further below.

When a mortgage is sold by the originator to a third party investor, mortgage originators and insurers may potentially have different interests. In these cases, mortgage originators are generally compensated on a mortgage origination fee basis and are incentivized to increase loan production. Mortgage insurers are compensated by insuring mortgages and charging a premium that offsets the cost of cumulative claims. If underwriting quality deteriorates, and mortgage insurance claims increase, without a commensurate increase in premium, mortgage insurers may incur losses, while mortgage originators are not financially affected by the mortgages' performance. This dynamic is understood in the United States, where this relationship is common, and several solutions have been developed to align the interests of mortgage originators and insurers. With proper supervision and guidelines, these solutions could provide effective methods of aligning interests and maintaining a strong/strong mortgage environment, as described in the report.

One method used for aligning the interests of mortgage originators and insurers is the provision of risk retention to the mortgage originator. There are multiple forms of risk retention, including proposed coinsurance regulations emanating from the Dodd-Frank Wall Street Reform and Consumer Protection Act. For certain mortgages, such regulations will require the mortgage originator to retain a financial stake in the performance of the mortgage and will subject the originator to credit losses if the mortgage defaults. Such a shared-risk framework directly aligns the interests of mortgage originators and insurers. A potential inconsistency in this framework is that there are exceptions to the risk retention requirement for mortgages whose performance is guaranteed by the U.S. government. When considering such exceptions on a global scale, regulators should work together to ensure that methods used to align the interests of mortgage originators and insurers are consistent across mortgage types and do not have unintended consequences for originators or insurers of any type of mortgage.

Another common method used to align the interests of mortgage originators and insurers is the use of a representation and warranty clause, common in insurance contracts. Mortgage insurers periodically review loan origination files to ensure that insured mortgages are originated in accordance with applicable underwriting standards agreed upon by the mortgage originator and insurer. If a loan does not meet the applicable underwriting standards, and provide sufficient documentation thereof, coverage may be rescinded, placing the risk back on the mortgage originators. In the alternative, if the loan resulted in a claim, the claim may be denied. The representation and warranty clause is designed to provide, among other things, a means of recourse for the mortgage originator if underwriting guidelines fail to meet minimum thresholds set by the mortgage insurer or investor.

The representation and warranty structure served as a significant point of friction between originators, investors, and insurers during the financial crisis. The process is resource-intensive and inefficient, and it may result in unexpected capital expenditures for mortgage originators. To address these shortcomings, U.S. government-sponsored enterprises (GSEs) and a number of mortgage insurers have introduced guidelines and products aimed at removing the uncertainty generated by this structure. We believe that the mortgage insurance industry and regulators should be able to identify better methods for aligning the interests of mortgage originators and insurers.

Recommendations 2, 3, and 6: supervisors' role in setting and maintaining underwriting standards

Generally, mortgage underwriting standards and guidelines should be the responsibility of those most at risk of loss, whether mortgage originators or mortgage insurers. Mortgage insurers develop premium structures to account for the risk assumed in insuring mortgages, and the mortgage insurance industry has increased the use of granular, risk-based pricing since the mortgage crisis and has adjusted prices for recent experience. These efforts should serve as an incentive for the industry to maintain strong underwriting standards, as more risky borrowers are charged premiums commensurate with their risk. The supervisor's role should be to concentrate on facilitating risk-based premium structures for mortgage insurers and ensuring that stated guidelines and legal compliance criteria are met.

For large insurers, including mortgage insurers, the National Association of Insurance Commissioners' (NAIC) 2015 implementation of the Own Risk and Solvency Assessment (ORSA) standards should assist supervisors in monitoring and crafting potential corrective action for any mortgage insurers with deteriorating underwriting standards. The ORSA document prepared by the insurer will include a discussion of the mortgage insurer's ERM framework, including an in-depth evaluation of the underwriting risks.

Generally speaking, a mortgage insurer's ERM framework should provide three lines of defense against behavioral incentives to lower underwriting standards: underwriters, risk management, and audit. An ERM framework begins with process guidance from the management team of the organization. For mortgage originators and insurers, this typically involves the risk management department, the underwriting department, and senior management setting underwriting guidelines for the mortgage insurer. The underwriting guidance outlines the types of mortgages and criteria acceptable to the organization, and that guidance is passed to the underwriting team, which approves loans that are acceptable to the organization. After helping to set underwriting guidelines, the risk management department is tasked with ensuring internal compliance with the guidelines and continuing to monitor for potential changes to the guidelines, along with tracking and evaluating the impact of any exceptions to the guidelines.

If the level of risk assumed by the organization is believed to be larger than what the organization deems acceptable, the underwriting criteria should be tightened. The third line of defense is the organization's internal audit function. Supervisors may effectively govern underwriting practices for the industry by monitoring the ERM process for mortgage insurers and similar practices at mortgage originators under a similar framework. Supervisors should work together in designing consistent monitoring practices for mortgage originators and mortgage insurers.

Finally, we agree that the FSB Principles for Sound Residential Mortgage Underwriting Practices outline a strong framework for mortgage underwriting that could be used in the mortgage insurance industry. Mortgage insurers currently follow most, if not all, of the FSB underwriting practices. On page 6, the report states that there is a "…danger that the existence of MI [mortgage insurance] may lead both the lender and the insurer to relax standards because 'the other party is looking at it.'" While we agree that danger may exist, a recent study[2] of U.S. mortgage insurance industry data supports the conclusion that the mortgage insurance industry avoided this danger during the recent crisis. In particular, the study highlights that, when mortgage insurers have approval authority, loans with mortgage insurance at origination default at a rate lower than similar mortgages without mortgage insurance, all else being equal. Mortgage insurers are often in a first-loss position in a mortgage default and have a direct interest in the performance of any insured mortgage. Therefore, it is in their interests to utilize industry best practices in underwriting standards.

Capital and Safety and Soundness Recommendations

Recommendations 4 and 5 from the report discuss (1) a mortgage insurer's ability to accumulate sufficient reserves and capital during the trough of the underwriting cycle to cover its obligations during the peak of the cycle; and (2) the need for bank and insurance supervisors to be cognizant of any cross-sectoral arbitrages that may exist due to different capital treatment of banks and insurance companies:

4. **Supervisors should require mortgage insurers to build long-term capital buffers and reserves during the valleys of the underwriting cycle to cover claims during its peaks.**
5. **Supervisors should be aware of and mitigate cross-sectoral arbitrage which could arise from differences in the accounting between insurers' technical reserves and banks' loan loss provisions, and from differences in the capital requirements for credit risk between banks and insurers.**

We support recommendations 4 and 5 proposed in the report and set forth above. Our comments on each of the specific underwriting recommendations are outlined below.

Recommendation 4: long-term capital buffers and reserves

There are four potential ways the existence of long-term capital buffers and reserves could be used to cover claims during peak claim cycles.

First, the contingency reserve currently required for mortgage insurers operating in the U.S. allows for the accumulation of capital during the valley of the underwriting cycle, above and beyond the protection provided by sensible capital requirements. However, as the U.S. mortgage insurance industry emerges from the financial crisis, it appears that the existence of the

---

[2]In a comment submitted on the notice of proposed rulemaking to six federal agencies responsible for developing the definition of a qualified residential mortgage, the Mortgage Insurance Companies of America submitted a study by Milliman that comprehensively analyzed comparable performance differences of privately-insured, low down payment loans against uninsured or "piggyback" loans in determining the probability of default. The analysis demonstrates that private MI is a controlling factor that mitigates the risk of default, especially during periods of mortgage market stress, when home values fall significantly. The study included the most recent crisis, and its conclusions demonstrate that, even during the crisis, the default rate on mortgages insured by private mortgage insurers was less than the comparable default rate for similar mortgages not insured by private mortgage insurers. Milliman Study Addressing the Technical Analysis of the Role of Private Mortgage Insurance in Reducing the Frequency of Default: *Mortgage Insurance Loan Performance Analysis as of March 2011*.

contingency reserve alone, in its current form, is insufficient to ensure the proper capitalization of mortgage insurers through all parts of the underwriting cycle. We encourage further analysis of the contingency reserve structure and the introduction of potential modifications to the structure as needed. The existence of a contingency reserve may also have an impact on the potential for cross-sectoral arbitrage, as discussed below.

Second, just as certain bank supervisors require banks to subject their portfolios to pre-determined stress tests, insurance company supervisors could regularly require mortgage insurers to run standardized stress tests or other capital adequacy tests against their portfolios. How a mortgage insurer performed on such tests would dictate the insurer's dividend-paying capability as well as its potential need to raise capital. A number of mortgage insurance companies operating in the U.S. support this type of approach, as illustrated by responses last year to the U.S. Department of Treasury, Federal Deposit Insurance Corporation, and Board of Governors of the Federal Reserve System's call for responses on the implementation of Basel III.

Third, in addition to the current regulatory requirement that qualified actuaries opine on insurance company loss reserves, actuaries could opine on other measures of insurance companies' capital strength. We support regulatory requirements for actuarial opinions on the loss and premium forecasts underlying the Premium Deficiency Reserve[3] (PDR) calculation and/or on the need to establish a PDR. Actuarial opinions on an insurer's PDR calculation could help ensure sufficient reserves are created during peak claim cycles.

Fourth, in the U.S., mortgage insurers are not subject to participation in state guaranty funds. To protect policyholders, we encourage the exploration of the creation of a guaranty fund into which mortgage insurers would contribute premiums. This guaranty fund would then be callable by supervisors if certain criteria were met. As the report mentions, in Canada, private mortgage insurance companies pay the Canadian government a premium, which provides some level of protection to policyholders.

Recommendation 5: cross-sectoral arbitrage

The CPC agrees that greater coordination between banking and insurance supervisory agencies is needed to mitigate potential cross-sectoral arbitrages. In the U.S., the Federal Reserve and the NAIC could work together to develop capital standards designed to prevent the availability of arbitrage opportunities.

As mentioned previously, we support the concept of a regulatory requirement for an actuarial opinion on these types of liabilities, including PDR. Such opinions could also be required for banks and other financial institutions for their loan loss reserves or other exposures that relate to

[3] A PDR reflects a potential reserve associated with the lifetime performance of insured mortgages. By contrast, loss or claim reserves are an estimate of the obligation of the mortgage insurer for future payments resulting from currently delinquent mortgages. Specifically, a statutory PDR exists if estimated future paid losses and expenses on unexpired business exceed the related future estimated premium revenue for such business on a present-value basis after consideration for the current loss reserve, unearned premium reserve, and contingency reserve. According to the Statement of Statutory Accounting Principle No. 58, when the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a PDR shall be recognized.

the type of risk assumed by mortgage insurers. As U.S. GAAP standards and the International Financial Reporting Standards continue to be refined, every effort should be made to eliminate or mitigate risk arbitrage opportunities to the greatest extent possible, including the consideration of insurance company contingency reserves, as noted above.

****

The CPC believes that the actuarial profession has much to contribute to the potential implementation of these recommendations and to similar efforts. We generally agree with the recommendations outlined in the CD and we look forward to future opportunities to assist the BIS or others within the industry to facilitate the prudent functioning of the mortgage insurance and banking industries.

If you have any questions about our comments, please contact Lauren Pachman, the Academy's casualty policy analyst, at pachman@actuary.org or (202) 223-8196.

Sincerely,

Michael E. Angelina, ACAS, MAAA
Vice President, Casualty Practice Council
American Academy of Actuaries