HVP Inc.

August 1, 2011

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Subject: Credit Risk Retention — *OCC (Docket No. OCC-2011-0002, RIN 1557-AD40), Federal Reserve System* (Docket No. R-1411, RIN 7100-AD-70)*, FDIC 3235-AK96), (RIN 3064-AD74), FHFA (RIN 2590-AA43), SEC (File No. S7-14-11, RINHUD (Docket No. FR-5504-P-01, RIN 2501-AD53); HVP Inc. Addendum to the Credit Risk Retention Comment Letter Focusing on Qualified Residential Mortgage Designation for Home Value Insurance that is State-Regulated and Reduces the Risk of Homeowner Mortgage Default*

Ladies and Gentlemen,

As an addendum to **HVP Inc.'s** comment letter of July 27, 2011, we are submitting, for your consideration, a fact sheet entitled *Top Ten Reasons to Include a "New Product" (Home Value Insurance) in QRM* and also a letter from Jack Guttentag, Professor of Finance Emeritus of the University of Pennsylvania's Wharton School, entitled "*Will Property Value Insurance Replace Mortgage Insurance?*" Both submissions provided strong reasons for why home value insurance should be included in the "Qualified Residential Mortgage" (QRM) exemption from risk retention requirements in the Dodd-Frank Act

We appreciate your adding this new material to our previously submitted comment letter, which supports including in the QRM definition <u>home value insurance</u> that is state-regulated and protects both homeowners <u>and</u> lenders by reducing the risk of defaults.

Thank you for your consideration.

Sincerely,

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Top Ten Reasons to Include a "New Product" (Home Value Insurance) in QRM

1) <u>Because the Dodd-Frank Act specifically provides for products that reduce the risk of default</u>:

- "…mortgage guarantee insurance **or other types of insurance or credit enhancement** obtained at the time of origination, **to the extent such insurance or credit enhancement reduces the risk of default**" -- Dodd-Frank Act, Section 941(B))

2) Because home value insurance reduces the risk of homeowner defaults

- There is strong empirical evidence that home value insurance reduces the risk of homeowner defaults. Proof comes from 14 published, econometric studies, which identify the three major causes for default: negative equity, illiquidity, and pessimistic views on future housing prices. **If properly constructed**, home value insurance addresses all of these key default causes. (*The aforementioned studies are the basis of HVP Inc.'s comment letter to regulators on QRM*).

3) Because mortgage guaranty insurance does not reduce the risk of default

- Mortgage guarantee insurance unintentionally promotes foreclosures because lenders are paid and the GSE's stop their guarantee payments only after a foreclosure sale. In addition, mortgage guaranty insurance does nothing to address negative equity, illiquidity, and pessimistic views on future housing prices, which are the main causes of homeowner defaults.

4) Because federal regulators have great confidence in state-regulated, state-licensed insurance

- Home value insurance must be "properly constructed," and significant components are state regulation and licensure, which entail rigorous statutory reserve requirements, exposure-to-reserve ratios, and capitalization requirements.

5) Because financial guaranty insurance is not a new product

- Home value insurance combines financial guaranty insurance and credit insurance. Neither type of insurance is new. In 1994, the National Association of Insurance Commissioners wrote and adopted the Financial Guaranty Insurance Model Act, which permitted the issuance of both financial guaranty and credit insurance policies in tandem.

6) Because home value insurance is a natural next step

- Mortgage insurance has been viewed as a *six-decade social experiment* that failed its most serious stress test – the 2007-to-2009 financial and economic crisis.

7) Because exclusion might mean extinction

- Including only mortgage insurance in the QRM provision means, de facto, excluding home value insurance because lenders will refer all their loans to mortgage insurance providers, thereby creating an insurmountable regulatory hurdle for home value insurance.

8) Because homeowners deserve a real choice

- With mortgage insurance, borrowers to pay to protect lenders. With home value insurance borrowers pay to protect themselves and lenders.

9) Because home value insurance has significant macroeconomic advantages

- Home value insurance stabilizes real estate prices and builds consumer confidence in declining markets.

10) Because, otherwise, nothing will change

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July 28, 2011

Will Property Value Insurance Replace Mortgage Insurance?
Jack Guttentag

Private mortgage insurance (PMI) in the US can be viewed as a social experiment that required 6 decades to assess. It took that long for the system to be stress-tested.

Our experience with private mortgage insurance (PMI) can be divided into two distinct periods: 51 more or less normal years from 1951 to 2006, during which loss rates were low. And the 4 plus post-crisis years beginning 2007, during which losses have been extraordinarily high and the industry has seen its reserves and capital become severely depleted.

With the benefit of hindsight, we now know how a well-designed private mortgage insurance system should work during a period of declining home prices and rising default and foreclosure rates. And we can compare our experience with PMI with what we might expect from an alternative approach waiting in the wings – property value insurance.

Loss Mitigation

A well-designed insurance system designed to cushion the effects of a widespread decline in home prices should reduce the losses of lenders and investors by paying claims out of reserves accumulated during normal periods. The PMIs have done that. While there have been some instances where the insurers have refused to pay lender claims on the grounds that the insured loans did not meet underwriting standards, this can be attributed more to their desperation than to an inherent weakness in the PMI model.

There is no reason to believe that property value insurance would work any better or any worse in mitigating lender losses.

Reducing the Incentive to Default

A well-designed insurance system should reduce the incentive of borrowers to default by cushioning declines in their equity. The high level of borrower defaults in recent years has been due to negative equity, the result of a nationwide decline in home prices.

When borrowers have positive equity, the myriad of factors that adversely affect borrowers' ability and/or willingness to make their payments, such as unemployment, family dissolution or sickness, seldom lead to default. In most cases, the afflicted borrowers sell their houses to retain the equity. When equity is negative, however, these distress situations lead to defaults. When negative equity is sizeable, furthermore, many borrowers default even though they are not in distress, just to get out of a hopeless situation.

Because PMI does not affect borrower equity, it does not affect their decision to default. In contrast, property value insurance covering borrowers would remove or reduce negative equity, which would reduce the incentive to default. This is the major advantage of property value insurance covering borrowers over PMI that covers lenders.

Indeed, assuming the insurer is properly reserved, property value insurance is a perfect substitute for down payment in the sense that the amount of insurance required to provide any target level of equity coverage is easily calculated. If 20% is the target equity, then the borrower who puts 10% down needs 10% property value coverage, and the borrower who puts 5% down needs 15% of coverage.

Encouraging Modifications Relative to Foreclosure

A well-designed insurance system should encourage lenders to modify the terms of mortgages to keep borrowers in their homes as an alternative to foreclosure. PMI does the reverse because lenders are not reimbursed for losses until loans have been foreclosed and the lender has submitted a bill. In the net present value calculation that loan servicers use in determining whether to modify a loan or to foreclose, PMI increases the present value of the foreclosure option relative to the modification option.

All the PMIs have developed programs designed to reduce foreclosures by making contributions to modification alternatives. If a foreclosure would cost the PMI $30,000 and they can make a modification happen with a good prognosis for $15,000, it pays to do it. The problem has been that each case has to be handled individually, servicers have been overwhelmed by the number of cases, and cash management has been chaotic. These programs are thus only a partial offset to the tendency of PMI to encourage foreclosure relative to modification.

The problem inheres in the process of insuring lenders against loss. It is a downside to loss mitigation. I see no reason why it would work any better if the lender had property value insurance.

PMI and the QRM Rule

Federal regulators seem to have lost their confidence in PMI. In its proposed rule establishing the requirements for a loan to be a qualified residential mortgage (QRM), they declined to consider PMI as an offset to a low down payment. This is a break from long-standing policy, which has been that loans with down payments of less than 20% were acceptable if they carried PMI, and if the insurance coverage was acceptable to Fannie Mae and Freddie Mac.

Given their focus on default risk, regulators should be receptive to proposals for property value insurance that cover borrowers as well as lenders.

Respectfully submitted,

Jack M. Guttentag
Professor of Finance Emeritus
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University of Pennsylvania