

**Comments of the Center for Economic Justice on the Mortgage Guaranty Insurance (E)
Working Group**

Concepts-List of Potential Regulatory Changes Paper

March 28, 2013

The most important characteristic of private mortgage guaranty insurance (PMI) markets is reverse competition. Reverse competition refers to a market in which the seller of the product markets the product not to the ultimate consumer of the product but to the entity referring the consumer to the seller. In the case of PMI, it is the lenders who hold the market power and can command considerations from PMI insurers in exchange for selection of the that particular insurer as the provider of PMI. The result of this reverse competition included PMI insurers entering into captive reinsurance schemes with lenders to funnel considerable portions of the PMI premiums to the lenders and PMI insurers accepting business risk with adequate underwriting or reserves.

Lenders should have no financial interest in the sale of PMI to borrowers except for the protection of the lenders' loans from default. When lenders have a financial interest in the sale of PMI beyond such protection – when PMI is a profit center for lenders – lenders then have an incentive (to accompany their market power) to dictate terms to PMI insurers to maximize the financial gains to the lender. In such a market, a PMI insurer that hews to solid underwriting and risk management will lose business to the PMI insurer willing to provide additional considerations to the lender.

One of the most important regulatory changes should be a total prohibition against a mortgage originator or servicer or affiliate of an originator or servicer from receiving any financial consideration from the sale of PMI other than the protection offered by the coverage. LPI insurers should be prohibited from providing any consideration from the sale of PMI other than the protection offered by the coverage to a lender, mortgage servicer or affiliate of the lender or mortgage servicer. Such a prohibition would promote beneficial competition by ensuring a level playing field based on insurance fundamentals, not kickbacks.

With this as background, we comment on the “primary problems” cited in the paper.

1. Overconcentration of mortgage origination activity in too few banks places competitive pressure on mortgage guaranty insurers to take everything allocated to them by a given bank or bear the consequences of receiving no business from that bank.

As stated above, mortgage originators have the market power in the PMI transaction. But, it is unclear why concentration among mortgage originators – which is much less than the very high concentration among PMI insurers – creates a problem of overconcentration of business for PMI insurers. While some mortgage originators performed better in terms of ultimate borrower defaults than others, it was the lack of effective underwriting by PMI insurers that led to acceptance of PMI exposures with risk far in excess of that anticipated by PMI insurers. If we assume that a PMI insurer will perform reasonable and necessary underwriting and due diligence, it is unclear why having a large book of business from 2 mortgage originators or 10 mortgage originators would make a great difference. If a real estate market collapse occurs, the impact will be similar across similar books of business regardless of the number of originators.

2. Mortgage guaranty insurance is a form of economic catastrophe insurance in which long periods of very great profitability are punctuated by periods of varying duration of catastrophic loss. Absent countervailing legal requirements, this leads to corporate income taxes and stockholder dividends that are excessive in relation to actual profits over the life of a company in this line of business.

Virtually all insurance protects against some form of economic catastrophe. Even if we accept the premise that PMI is characterized by long periods of below average claims punctuated by periods of highly above-average claims, the proper insurance regulatory response is to require appropriate claim reserves so excessive amounts of premiums cannot be paid out in profits or taxes during below-average claims periods. This is not an issue unique to PMI or a problem with PMI products or market; it is a problem with solvency regulation of PMI.

3. Mortgage guaranty insurance is sufficiently profitable during the long periods of great profitability that there would be some disincentive to underwrite the business attentively even in the absence of the cut-off threat from banks. It is not alone among the forms of consumer credit insurance for which this is the case.

The phrase “sufficiently profitable during the long periods of great profitability that there would be disincentives . . .” does not make sense. Other than PMI and bond insurance related to collateralized debt obligations, it is unclear what forms of consumer credit insurance exhibit the problem described. Regulators can certainly do a lot to ensure PMI insurers engage in appropriate underwriting, pricing and reserving.

We are troubled by the tone of the three “primary problems.” The description of the problems seems passive; as if the collapse of the PMI industry was an act of God. In fact, the collapse of the PMI industry was the result of major failures of PMI insurers and regulators. Regulators took no action to rein in the various schemes employed by PMI insurers to provide considerations to mortgage servicers and failed to require adequate reserves for business written by PMI insurers. PMI insurers – who are in the business of risk management – failed spectacularly to practice risk management.

While the description of the problems with PMI markets in the concept paper is weak, the potential regulatory changes include most of the needed changes, including improved regulatory of PMI underwriting standards and practice, improved regulatory oversight of PMI risk management, improved data reporting for regulatory oversight and public accountability, vastly increased capital and reserve requirements and eliminating mortgage originator financial incentives in the sale of PMI. In our view, some of the exotic recommendations are not needed or desirable.