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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).***

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,

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