UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF WISCONSIN

MORTGAGE GUARANTY INSURANCE CORPORATION,

Plaintiff,

vs.

Civil Action No. ______________

FEDERAL HOUSING FINANCE ADMINISTRATION, in its capacity as conservator for Federal Home Loan Mortgage Corporation, and FEDERAL HOME LOAN MORTGAGE CORPORATION,

Defendants.

COMPLAINT FOR DECLARATORY RELIEF

Mortgage Guaranty Insurance Corporation, for its complaint against defendants Federal Housing Finance Administration and Federal Home Loan Mortgage Corporation, alleges as follows:

NATURE OF ACTION

1. This is an action for declaratory relief pursuant to the Federal Declaratory Judgment Act, 28 U.S.C. § 2201. This dispute concerns the proper interpretation of a series of mortgage insurance policies issued by plaintiff Mortgage Guaranty Insurance Corporation ("MGIC") to defendant Federal Home Loan Mortgage Corporation ("Freddie Mac"), which today operates under the direction and control of its conservator, the Federal Housing Finance Administration ("FHFA").

THE PARTIES

2. Plaintiff Mortgage Guaranty Insurance Corporation is a Wisconsin insurance company with its principal place of business in Milwaukee, Wisconsin. MGIC provides private mortgage insurance, as well as risk management products and services, to mortgage lenders and investors. Founded in 1957, MGIC was the nation's first modern private mortgage insurance company, and it remains the nation's largest private mortgage insurer as measured by primary insurance in force at March 31, 2012. MGIC is the principal operating subsidiary of MGIC Investment Corp., whose stock is publicly traded on the New York Stock Exchange.

3. Defendant Federal Housing Finance Administration is a federal government agency created on July 30, 2008, to oversee the operations of Freddie Mac, the Federal National Mortgage Association ("Fannie Mae"), and the Federal Home Loan Banks. On September 8, 2008, FHFA was appointed as conservator for Freddie Mac as well as for Fannie Mae. As a consequence, FHFA controls and directs the business of Freddie Mac today. FHFA is sued in this matter in its capacity as conservator for Freddie Mac.

4. Defendant Federal Home Loan Mortgage Corporation is a federally-chartered, publicly-traded corporation with its principal place of business in McLean, Virginia. Freddie Mac, created in 1970, is a special-purpose government-sponsored enterprise ("GSE") charged by Congress with enhancing the availability and uniformity of residential mortgage loans across the nation. Along with its sister GSE, Fannie Mae, Freddie Mac has purchased billions of dollars in residential mortgage loans originated by private and government-agency lenders, thereby freeing up lenders' capital to make further home loans. Fannie and Freddie fund these purchases in large part through the sale of mortgage-backed securities backed by these loans.

JURISDICTION AND VENUE

5. This Court has jurisdiction pursuant to 12 U.S.C. § 1452(f)(2) (all civil actions involving Freddie Mac deemed to arise under federal law, district courts have original jurisdiction over such actions) and 28 U.S.C. § 1331 (original jurisdiction over actions arising under federal law).

6. Venue is proper in this district pursuant to 28 U.S.C. § 1391(e), inasmuch as a substantial part of the events or omissions giving rise to the claims occurred in this district.

FACTUAL ALLEGATIONS

Private Mortgage Insurance

7. Private mortgage insurance is insurance that protects a home mortgage lender, or as here a subsequent investor who purchases a mortgage loan, against the risk of loss resulting from a borrower default. Lenders and investors generally seek mortgage insurance on "low down payment" loans, those where the borrower has made a down payment of less than 20% of the purchase price and hence the original "loan to value" ("LTV") ratio for the loan exceeds 80%. Experience and research show that a borrower with less than 20% invested in a home is more likely to default on a mortgage loan. The availability of private mortgage insurance to protect against that added risk makes it possible for many prospective homeowners who cannot afford a 20% down payment nonetheless to purchase a home.

8. Private mortgage insurance is generally written either in the form of "primary" or "pool" insurance. Primary mortgage insurance insures individual loans, with coverage limits that apply on a loan by loan basis (typically covering the "top" 20-30% of the loan amount). Pool insurance, by contrast, cover a large group or pool of loans, with a single loss limit applicable to the entire pool typically calculated as a percentage of the total balance of all insured loans.

Loans covered by pool insurance may or may not also have primary insurance; if they do, the pool insurance is "supplemental" to the coverage provided by the primary mortgage insurance, covering any remaining losses incurred after receipt of primary insurance. Pool insurance is generally used as an additional "credit enhancement" for certain secondary market mortgage transactions. The present case involves pool insurance obtained for this purpose.

Mortgage Insurance Capital Requirements

9. As the past few years attest, mortgage defaults occur in cycles. One consequence of this phenomenon is that mortgage insurers experience extended periods of time in which their paid claims are significantly lower than the insurance premiums collected, followed by periods of time in which paid claims may vastly exceed the premiums being collected during that same period.

10. To deal with the cyclical nature of this risk, mortgage insurers are subject to stringent capital and other requirements. For example, mortgage insurers, like other insurers, are obligated to maintain minimum capital levels relative to their outstanding "risk in force" (or a similar measure), which constrain the amount of insurance they can write (the "Capital Requirement"). If a mortgage insurer cannot meet the Capital Requirements in a state, then it cannot write additional new insurance in that state unless regulatory authorities determine to grant a waiver. Further, if a mortgage insurer cannot meet the Capital Requirements of its domiciliary state—in MGIC's case, Wisconsin—then it cannot write new insurance in any state absent a regulatory waiver. Wis. Adm. Code INS § 3.09(5)(b).

11. While formulations of the minimum Capital Requirement may vary in certain jurisdictions, the most common measure applied allows for a maximum permitted risk-to-capital

ratio of 25 to 1. Because MGIC wished to issue policies in jurisdictions that used this measure, it was important to MGIC to meet the 25-to-1 risk-to-capital ratio requirement.

12. Wisconsin does not regulate capital by using a risk-to-capital measure, but instead requires that a mortgage insurer maintain a minimum policyholders position ("MPP"). The "policyholders position" of a mortgage insurer is its net worth or surplus, contingency reserve, and a portion of the reserves for unearned premiums. Under Wisconsin law, the portion of policyholders position that must be allocated to a particular policy depends on the nature of the policy and the types of loans covered, with more stringent requirements generally applicable to pool policies than to primary policies. Wis. Adm. Code INS §§ 3.09(3)(m), 3.09(5). Because MGIC had to maintain a sufficient MPP to be certain it could write any new insurance at all, it was even more critical that MGIC meet this Capital Requirement.

13. The amount of a mortgage insurer's risk-in-force is determined by the combined "aggregate loss limit," also referred to as a policy limit or "stop loss," currently outstanding on all policies issued by the insurer. Because the applicable Capital Requirements constrain a mortgage insurer's ability to write new insurance, the calculation of aggregate loss limits is very important to a mortgage insurer. Even if there are no insured loans in default and no (or few) expected claims to be paid, the higher the total of all aggregate loss limits, the less new insurance can be written.

14. In addition, when the pool policies that are the subject of this lawsuit were entered into, the maintenance of a claims-paying ability rating of at least AA-/Aa3 was critical to a mortgage insurer's ability to continue to write new business. In assigning claims-paying ability ratings, rating agencies reviewed, among other things, a mortgage insurer's adequacy of capital to withstand extreme loss scenarios under assumptions determined by the rating agency. Further,

MGIC itself imposed an internal limit on the percentage of its total risk that could be accounted for by pool (as opposed to primary) insurance.

15. As a result, the aggregate loss limit, and how long it would be in place, was critical to MGIC because it affected how much insurance, and pool insurance in particular, it effectively could write.

The Pool Policies Issued By MGIC to Freddie Mac

16. In 1996, 1997, and 1998, Freddie Mac purchased a total of eleven pool mortgage insurance policies from MGIC, denominated as policies 3151, 3152, 3157, 3164, 3169, 3170, 3172, 3173, 3188, 3193, and 3206 (collectively, the "Policies"). Each of the Policies insured multiple pools of loans. Each individual loan pool (also known as a "funding") was comprised of loans that Freddie Mac purchased from a specific lender or lenders over the course of a "fill-up period" that typically lasted from six to twelve months. As addressed further below, over time additional loan pools were added under the Policies, so that ultimately each Policy covered multiple pools of loans made by different lenders at different points in time. After 2001, all newly-insured loan pools were added to Policy 3206, with the last group of loan pools added in 2007.

17. Under the Policies, loans in a given loan pool were insured for a defined coverage period measured from the end of the fill-up period, after which time coverage terminated and the loans ceased to be insured. For most of the loan pools the coverage period was 10 years, although certain pools had longer coverage periods of up to 20 years. The date on which coverage terminates for a particular loan pool is referred to as the "sunset" date. Because the end of the first fill-up period was in 1997, the first sunset date occurred in 2007. The last sunset date will occur in 2018.

18. Premiums were established on an individual loan pool basis and were paid either by Freddie Mac or by the lender "on behalf of" Freddie Mac. For some pools the premium covering the (typically 10-year) term of insurance was paid in a single installment up front, while in other cases premiums were paid annually through their term of coverage.

19. Each of the Policies included an aggregate loss limit ("ALL"), also referred to as the policy limit or "stop loss," calculated as a percentage of the total initial principal balance ("IPB") "of all the loans insured under the policy." As discussed further below—and the nub of the parties' dispute—calculation of the aggregate loss limit based upon the initial principal balance of loans "insured under the policy" necessarily meant, and was understood to mean, that the IPB of a particular loan was included in calculating the ALL <u>only so long as</u> the loan was "insured." Once the term of insurance on that loan expired, it was no longer insured and thus was no longer relevant in calculating the ALL. Indeed, this is the only reading of the Policies that makes any sense.

20. Nine of the Policies provided for an aggregate loss limit equal to 0.8% of the total initial principal balance of all insured loans, while the other two Policies had ALLs equal to 1.0% and 1.25% of the total IPB of loans insured under the policy.

21. As addressed above, MGIC is required under Wisconsin law to meet a Capital Requirement (minimum policyholders surplus) calculated based in part upon its cumulative outstanding aggregate loss limits or "risk in force" at any given point in time. For each loan pool insured under a Policy, therefore, MGIC was thus obligated to commit sufficient capital to support the aggregate loss limit for that loan pool—and to maintain that capital for so long as the term of insurance lasted for that pool. The aggregate loss limit under each pool, as well as the coverage term (10 to 20 years) during which that limit would be in place, thus were critical to the

calculation of MGIC's short-term and long-term capital position, and hence to its ability to maintain an acceptable claims-paying ability rating and to write new business.

<u>The Mega Pool Endorsement</u>

22. During 1998 and 1999, Freddie submitted an ever-larger number of loans for insurance under the eleven Policies. As of June 30, 1998, the eleven loan pools included loans totaling approximately $35 billion in initial principal balances. By September 30, 1999, the combined IPBs of the loans insured under all eleven pool Policies totaled $76 billion, with a weighted average loss limit of approximately 0.85%. After payment of modest losses in the initial years of the Policies, the remaining combined aggregate loss limits of the Policies—MGIC's amount at risk—totaled approximately $647 million.

23. The large risk exposure faced by MGIC as a result of the growth of the Freddie Mac pools "spent" a substantial portion of MGIC's available capital for regulatory and ratings agency purposes, thus constraining MGIC's ability to write additional insurance for Freddie Mac as well as other customers so long as that risk remained in force. This presented a significant issue not only for MGIC but also for Freddie Mac, which was concerned about its ability to obtain sufficient private mortgage insurance for the low down payment loans it anticipated purchasing in coming years. To address this concern, MGIC and Freddie Mac began, in Freddie Mac's words, "actively working" to "free up [MGIC's] capital" by restructuring the existing Policies in order to "buoy MGIC's capacity to provide additional coverage." As part of this effort, Freddie Mac pressed MGIC for assurances that it would indeed obtain "new pool insurance capacity" from MGIC, including "capacity that we free up by restructuring our existing policies."

24. The parties' lengthy discussions culminated in a restructuring of the eleven Policies, completed in 2000 with an effective date of October 31, 1999. As agreed by the parties, each of the Policies was amended by a substantively identical endorsement that (a) kept each Policy separate, but replaced the eleven individual aggregate loss limits with a single, combined aggregate loss limit calculated by combining loans insured under each Policy into one "mega pool" for aggregate loss limit purposes; and (b) establishing the combined aggregate loss limit at the greater of (i) the "existing aggregate loss limit," calculated based upon the respective total initial principal balances and existing aggregate loss percentages for each of the Policies, or (ii) 0.69% of the combined total initial principal balance of both loans "insured" under the eleven pool Policies and loans which "become insured" under those Policies.

25. The changes put in place by the Mega Pool Endorsement accomplished multiple objectives. First, it provided Freddie Mac with the substantial benefit of "cross-collateralization" among the eleven Policies. Each Policy covered loan pools purchased from different groups of lenders, at different times, and each pool had different risk characteristics. It was thus understood that the relative overall loss experiences under the various Policies likely would not be the same, and hence one Policy might reach its limits even while other Policies had "unused" coverage available. By combining the eleven separate individual aggregate loss limits into a single, combined limit, Freddie Mac obtained a substantially reduced risk that defaults on loans from a particular lender or lenders, geographic region, or time period could lead to losses that exceeded the separate limit under any given Policy.

26. Second, the Mega Pool Endorsement reduced the amount of Regulatory Capital that MGIC needed to support additional insurance written under the Policies as that business grew in the coming years, as the parties anticipated would (and did) occur. The impact of this

reduction on MGIC's capital position benefitted both MGIC and Freddie Mac, as it permitted MGIC to extend additional insurance to Freddie Mac consistent with the need to maintain MGIC's claims-paying ability rating. The Mega Pool Endorsement was not intended to, and did not, ultimately increase the amount of Regulatory Capital that MGIC would be required to hold, as Freddie Mac now contends.

Growth in the Insured Loan Population

27. Through 1999, a total of $77.9 billion in initial principal balance was insured under the Policies. Following the effective date of the Mega Pool Endorsement, additional loan pools were insured under the Policies as the parties anticipated.

28. From 2000 through 2007, a further $113.6 billion in initial principal balance was added under the Policies. After 2001, all new originations were placed into Policy 3206, which came to be known as the "Large Policy." The remaining ten policies came to be known as the "Seasoned Policies" (or "Very Seasoned Policies").

29. MGIC agreed to write new insurance under the existing mega pool Policies only because of its understanding and belief, reflected in the language of the Policies, that the initial aggregate loss limit for a particular pool of loans "insured under the Policy" ceases to count in calculating the remaining combined aggregate loss limit for the mega pool at such time as that pool of loans ceases to be insured. Absent the combined aggregate loss limit working in this manner the Policies, and the Mega Pool Endorsement in particular, simply make no economic sense for MGIC.

<u>The Parties Act Consistent With the Language and Intent of the Endorsement</u>

30. At the time of and after execution of the Mega Pool Endorsement, MGIC understood and treated the terms of that endorsement—including the sunset provisions—in the manner set forth above. Once the sunset dates began to occur in 2007, MGIC commenced to "roll off" the aggregate loss limit associated with the expiration of insurance on individual loan pools as loans reached their sunset dates and ceased to be insured. MGIC's regulatory filings with the Wisconsin insurance commissioner's office, as well as the periodic reports filed by MGIC's parent, MGIC Investment, with the U.S. Securities and Exchange Commission, reflected these sunset amounts—$92.0 million during 2007; $191.9 million during 2008; $124.4 million in 2009; and $122.8 million in 2010.

31. Although new loan pools continued to be placed in the Large Policy into 2007, beginning that year Freddie Mac obtained insurance from MGIC on new pools going forward through eight new pool policies that were <u>not</u> part of the mega pool. Ultimately, Freddie Mac insured loan pools totaling approximately $15 billion in IPB under these policies. Each of these policies had an aggregate loss limit of 1.00% of the IPB of the insured loans, as compared to 0.69% under the mega pool.

32. This step made sense for Freddie Mac because—and only because—aggregate coverage available under the mega pool Policies due to loans already covered started to decline rapidly beginning in 2007 as individual loan pools reached their sunset dates and coverage ended, and by the "out years" of the insurance on post-2006 loans would essentially be gone. As a result, Freddie received a greater degree of coverage by obtaining a 1.00%-based aggregate loss limit on the new loans on a stand-alone basis rather than including them in the mega pool on a 0.69% basis.

33. This would not have been the case, however, were it then understood—as Freddie Mac now claims—that the aggregate loss limit under the mega pool Policies never went down until 2018, ten years after the end of the very last fill-up period on the very last loan pool insured, and years after insurance had expired on nearly all loans at one time covered under the Policies. Had Freddie held this belief in 2007, it thus undoubtedly would have sought to include these additional loans under the Policies. It did not.

34. Communications between MGIC and Freddie Mac also reflected the understanding that a step-down in the aggregate loss limit occurred as individual loan pools ceased to be insured. During 2008, the parties discussed a potential transaction in which MGIC proposed to terminate a portion of its remaining exposure under the Seasoned Policies (*e.g.*, all but the Large Policy). MGIC was interested in such an arrangement as a means to accelerate the "fall off" of risk that would occur in the ordinary course as various pools insured under the Seasoned Policies reached their sunset dates. The specifics of this "fall off" of the then-remaining $375.3M of risk—with dollar amounts by year, corresponding to the expiration of insurance on individual loan pools, were set forth in a May 15, 2008 email from an MGIC executive to executives at Freddie Mac. This email noted explicitly that "most of [the] risk remaining on the seasoned policies will be unwinding due to their natural expiration dates during the remainder of 2008 and throughout 2009 . . . . [M]ost of this risk would be removed by the end of 2009 decreasing the amount of capital allocation to these policies, as well as MGIC being removed from any loss exposure on the loans being removed."

The Parties' Dispute Regarding Calculation of the Aggregate Loss Limit

35. On September 8, 2008, Freddie Mac was placed into conservatorship, with FHFA appointed as conservator. FHFA has controlled Freddie Mac's operations since that date, and plays a central role in all important decision-making at Freddie Mac.

36. In 2009, during the course of discussions regarding an unrelated new insurance program, Freddie Mac offered up a new interpretation of the Mega Pool Endorsement, taking the position that the consolidated aggregate loss limit is <u>not</u> reduced when a loan pool reaches its sunset date notwithstanding that the loans are no longer insured. Rather, according to Freddie Mac, the aggregate loss limit simply builds as new loans become part of the mega pool, and never reduces until it disappears entirely upon the sunset date of the last loan pool covered under any of the Policies.

37. Under Freddie Mac's position, pool insurance for which it paid a ten-year premium would, in effect, continue far beyond the ten-year sunset date after which the loans on which the premiums were paid are no longer insured under the Policies. This was never the intent of the parties, and is contrary to the mandate in the Mega Pool Endorsement that the aggregate loss limit be based on the initial principal balance of loans "insured" under the Policies—not loans "insured or previously insured."

38. Freddie Mac's interpretation leads to absurd results on multiple fronts. First, as discussed above, had Freddie Mac believed this interpretation in 2007, it would have made no sense for it to insure loans under new pool policies rather than under the existing Policies.

39. Further, the interpretation of the Policies leads to the entirely illogical result that the mega pool has a constant combined aggregate loss limit of over $1.3 billion for a period of more than ten years—from 2007 until 2018—lasting many years after coverage has actually

ceased for the vast number of individual loan pools at one time insured under the Policy. This is a result that would never have made sense for MGIC from a Capital Requirements perspective, or otherwise.

40. Following the revelation that Freddie Mac was advancing an interpretation of the Policies directly contrary to MGIC's long-held understanding as well as common sense, MGIC sought to engage Freddie Mac in discussions intended to clear up Freddie Mac's misreading of the parties' contract. To date, those efforts have not been successful.

41. As of the present date, MGIC has now received total claims from Freddie Mac that, if determined valid after appropriate review and consideration by MGIC, will more than exhaust the current remaining aggregate loss limit applicable to the mega pool as calculated by MGIC, but not as calculated by Freddie Mac. Thus, MGIC will very shortly begin denying claims that Freddie Mac asserts should be paid. Further, it is clear that in the coming months millions of dollars of additional claims will be submitted for payment under the Policies, and for which MGIC believes no coverage exists. The parties thus have a present and real controversy ripe for resolution by this Court.

42. As more fully set forth above, the intent and terms of the Policies, inclusive of the Mega Pool Endorsement, are that the initial aggregate loss limit for a particular pool of loans "insured under the Policy" ceases to count in calculating the remaining combined aggregate loss limit for the mega pool at such time as that pool of loans ceases to be insured;

43. MGIC is entitled, pursuant to the Declaratory Judgment Act, to declaratory relief holding that the foregoing interpretation of the Policy is correct and holding that MGIC may therefore deny all pending and future claims submitted by Freddie Mac once the remaining combined aggregate loss limit for the mega pool, calculated accordingly, has been exhausted.

44. In the alternative, MGIC is entitled to declaratory relief holding that the terms of the Policies, inclusive of the Mega Pool Endorsement, should be reformed to conform to the intent and understanding that the initial aggregate loss limit for a particular pool of loans "insured under the Policy" ceases to count in calculating the remaining combined aggregate loss limit for the mega pool at such time as that pool of loans ceases to be insured, and holding that MGIC may therefore deny all pending and future claims submitted by Freddie Mac once the remaining combined aggregate loss limit for the mega pool, calculated accordingly, has been exhausted.

PRAYER FOR RELIEF

WHEREFORE, plaintiff MGIC prays for relief as follows:

A. For a declaratory judgment holding that the intent and terms of the Policies, inclusive of the Mega Pool Endorsement, are that the initial aggregate loss limit for a particular pool of loans "insured under the Policy" ceases to count in calculating the remaining combined aggregate loss limit for the mega pool at such time as that pool of loans ceases to be insured, and further holding that MGIC may therefore deny all pending and future claims submitted by Freddie Mac once the remaining combined aggregate loss limit for the mega pool, calculated accordingly, has been exhausted;

B. In the alternative, for a declaratory judgment holding that the terms of the Policies, inclusive of the Mega Pool Endorsement, should be reformed to conform to the intent and understanding that the initial aggregate loss limit for a particular pool of loans "insured under the Policy" ceases to count in calculating the remaining combined aggregate loss limit for the mega pool at such time as that pool of loans ceases to be insured, and further holding that MGIC may therefore deny all pending and future claims submitted by Freddie Mac once the remaining combined aggregate loss limit for the mega pool, calculated accordingly, has been exhausted;

B. An award of MGIC's costs of suit; and

C. Such additional declaratory and other relief as the Court deems just and proper.

DATED this 16th day of May, 2012.

Respectfully submitted,

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