

May 31, 2001

Basle Committee Secretariat
Basle Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basle, Switzerland

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the Committee for Bank Supervision's most recent revisions to the Basle risk-based capital rules for banks ("Basle 2"). MICA is the trade association for the U.S. mortgage insurance industry. Members now provide credit insurance for over \$ 650 billion of loans with high loan-to-value (LTV) ratios in the United States, playing an important role in ensuring affordable access to home ownership for borrowers who lack the cash for a sizable down-payment. The mortgage insurance (MI) industry is also becoming increasingly significant in other nations, most notably Australia, the United Kingdom, Israel and Hong Kong.

The Basle 2 proposal includes significant revisions to the treatment of credit risk mitigation (CRM) in both the standardized and internal ratings-based (IRB) approaches. MI is now the most widely used form of CRM for high-LTV mortgages in the U.S., and MICA members therefore have a keen interest in how the Basle 2 rules would affect credit risk mitigation. However, our interest goes beyond the specifics of how CRM is treated and the relative competitiveness of different forms of CRM that may result. Any changes in the Basle rules that adversely affect the availability of a proven, cost-effective form of CRM for home ownership-related credit will have profound macroeconomic and public policy consequences. It is therefore essential that Basle 2 create the proper incentives for banks to acquire adequate amounts of effective CRM for mortgage risk.

MICA urges the Committee to:

- accord equal footing for CRM provided by all regulated counterparties, not just banks and securities firms;
- approach credit derivatives with extreme caution as an approved form of CRM;
- recognize that mortgage risk is highly variable, avoiding a simple 50% weighting for mortgages in the standardized approach; and
- revise the internal ratings-based models to better reflect the real risks of high loan-to-value mortgages.

Our comment also includes some technical concerns detailed at its close.

REGULATED CRM PROVIDERS SHOULD GET EQUAL TREATMENT

The Basle 2 proposal includes a significant revision to the treatment of CRM from the current capital framework. In general, MICA commends the Committee for permitting CRM to be more broadly recognized. The capital rules should, wherever possible, create incentives for prudent behavior. Providing capital relief when CRM is obtained creates a positive incentive for banks to reduce their risk profile, and it is thus an appropriate revision to the Basle framework.

However, in providing recognition for CRM, the Committee has established a preference for guarantees and insurance provided by banks and securities firms. A zero "w" factor or hair-cut is included in the formula for determining the capital weighting for assets backed by CRM provided by banks and securities firms. In contrast, a 15% "w" is included for "corporate" guarantees or insurance from parties rated A or better, including insurance companies. The rationale for this difference, as expressed in the Basle 2 proposal, is that banks and securities firms are extensively regulated and supervised, in contrast to corporate backers. This is not an accurate statement with regard to MI. Indeed, as shall be discussed in more detail below, MI is better capitalized and more extensively regulated than securities firms in many jurisdictions, and its regulation ranks at least equal with that of banks.

In the U.S., mortgage insurers are regulated by the states, consistent with the U.S. framework of state regulation of the insurance industry as a whole. State regulation is in no way inferior to federal regulation, and

in many respects it can be more stringent. Insurance companies operating nationwide must operate at the highest level established by the states to function within a consistent set of rules. State supervision ensures a very detailed approach to compliance and capital adequacy in every state in which an MI operates.

As noted, MI capital requirements are very high. Mortgage insurers are required to hold capital at a 25:1 ratio. To assure a AA- claims-paying ability rating from a major rating agency, however, insurers must hold capital at a higher ratio and, in fact, the industry now holds a 14:1 ratio. All MIs are AA rated or better – an essential benchmark for remaining competitive in the U.S. private MI industry. This is in sharp contrast to the U.S. securities industry, where leverage ratios are typically 27:1 or higher and ratings can vary widely.

MICA urges the Basle Committee to revise the capital accord to provide equal treatment for well regulated providers of credit risk mitigation, giving domestic regulators the power to introduce a haircut for corporate guarantors or insurers which are not subject to bank- or securities industry-like regulation. This will ensure that highly-rated, well-capitalized providers of CRM compete on fair terms with banks and securities firms, providing banks with a wide choice of CRM providers from which to choose.

CREDIT DERIVATIVES SHOULD BE APPROACHED WITH CAUTION

As noted, MICA supports the proposed revisions in Basle 2 that would expand the use of CRM. However, we think it is essential that CRM be provided by proven counterparties with a demonstrable ability to absorb risk over time. Indeed, these are the criteria established by the Committee for Bank Supervision in its January, 2000 consultative paper on credit risk mitigation. MICA believes that credit derivatives do not meet the criteria for reliable CRM and thus should be approached by the Committee with extreme caution. Allowing banks to rely too greatly on this unproven form of CRM could result in unanticipated risks to the banking system as credit risk that turns out not to have been properly hedged returns to haunt selling banks.

MICA supports the proposed change that will vary the weighting for credit derivatives by that of the counterparty, instead of the uniform favorable weighting now provided. This appropriately recognizes the growing market presence of lower-rated credit derivative

counterparties. We further support limiting the types of credit derivatives authorized in the standardized and foundation IRB approaches. However, MICA urges the Committee to go further, differentiating the formula for recognized CRM in the form of a credit derivative from that provided for tested guarantees and insurance. We recommend introduction of an additional factor in the CRM formula to reflect the fact that CRM is in the form of a credit derivative, and that the hair-cut provided in that formula be 50 bps.

RESIDENTIAL MORTGAGE RISK SHOULD BE DIFFERENTIATED

The standardized model suggests a uniform 50% risk weighting for residential mortgages. The formulas in the foundation and advanced IRB models come up with widely different risk weightings for different types of mortgages which, as shall be demonstrated below, are not consistent with the Committee's expressed desire to have capital fall as institutions move from the standardized to the more sophisticated IRB models. Setting the standardized risk weighting for high-risk mortgages at 100% would remedy these defects. Institutions could still receive a 50% risk weighting for mortgages if the risks related to them are mitigated through use of CRM. We would propose that the Committee consider the current approach used by U.S. regulators which permits a 50% risk weighting only to prudently underwritten loans with loan to value ratios below 85%, which recognizes that non-standard loans and loans with higher loan-to-value have a significantly greater probability of default and higher severity at default.

Such differences in expected losses can be viewed using the Committee's definition of default (loans delinquent 90 days) and loss severity rates by initial LTV, assuming that sales of foreclosed property occur with a discount of 15% from the original market value. The following tables demonstrate the degree to which mortgage risk increases as LTV climbs, and its correlation to the default probability of borrowers with impaired credit (i.e., subprime loans). Loss is calculated using default probability and severity of loss and shown as a ratio of expected losses to losses on "benchmark" 80% LTV prime loans. Loans are categorized by loan quality, LTV and loan age. Data on over 90 day delinquencies are derived from Mortgage Information Corporation's U.S. nationwide delinquency data for conventional residential loans during the past four years.

Ratios of Estimated Expected Losses Based On Last Four Year Average 90+ Delinquencies

Relative to Prime 80 LTV Mortgages Serving As Benchmark For Prudently Underwritten Loans

Fixed Rate Prime Loans	Year1	Year2	Year3	Year4	Year5	Year6	Year7	Straight Averages
<=70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
71-75	0.23	0.22	0.24	0.24	0.23	0.23	0.22	0.23
76-80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
81-90	4.02	3.76	3.65	3.49	3.35	3.35	2.91	3.50
91-95	6.84	7.36	7.84	8.10	7.90	8.25	6.12	7.49
96-105	14.71	16.75	18.00	18.32	18.84	17.82	14.44	16.98

Fixed Rate A Minus								
<=70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
71 - 75	3.67	3.09	2.15	1.53	1.37	1.08	0.70	1.94
76 - 80	21.89	18.17	14.53	11.50	9.93	10.17	5.70	13.13
>80	40.55	39.33	29.54	22.48	18.70	20.40	13.37	26.34

Fixed Rate "B" Loans								
<=70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
71 - 75	11.83	8.24	4.78	3.77	2.58	2.14	2.28	5.09
76 - 80	60.84	39.77	26.21	20.81	17.89	17.18	11.64	27.76
>80	104.87	76.95	52.45	38.89	36.83	44.94	24.21	54.16

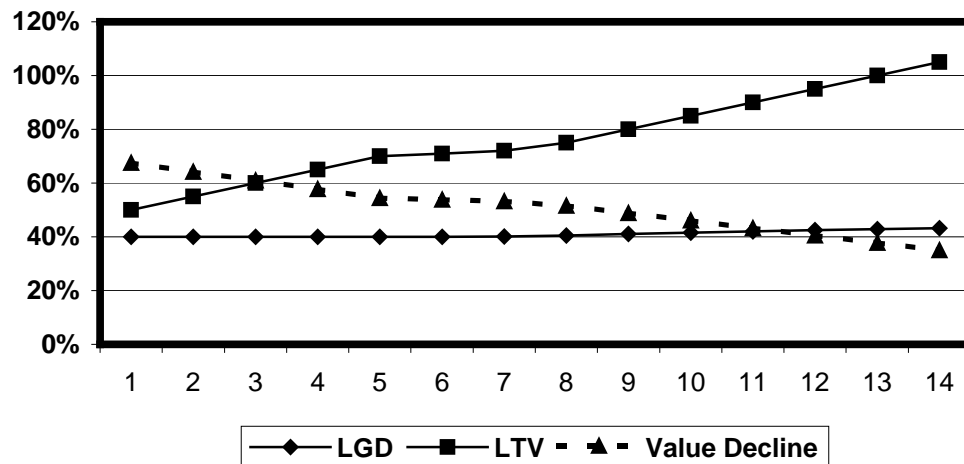
Subprime loans should only be given a 50% risk weight if they have an LTV of 70 or less. U.S. regulators have already raised concern regarding concentrations of subprime lending by increasing the minimum capital for such loans to a 150% risk weighting. By our example, such loans clearly present risks that are substantially above a standard of prudently underwritten loans. Such loans are not only a significant presence in the U.S., but are also gaining popularity in the UK and other countries.

THE IRB HAS ADDITIONAL PROBLEMS

The foundation IRB approach uses bank estimates of probability of default and a supervisory estimate of loss severity. The proposal includes a single formula that sets the loss given default (LGD) within a range of 40-50%.

However, testing the formula for application to mortgage loans reveals a significant inconsistency. In order for the mortgage loss severity by LTV to equal the proposed formula, a low-LTV property must suffer disproportionately higher declines in value, as demonstrated in the chart below:

**Value Decline Required By LTV to Equal Foundation
LGD By LTV**



We recommend that the Committee use a uniform target of loss in market value upon which loss severity would be calculated by original loan-to-value, to include all expenses related to the foreclosure process as well as the full cost-of-carry until the asset has been sold.

Another concern with the IRB is its focus on one year of losses. If one examines actual 90 day plus delinquencies by age of loan for residential mortgages, the average delinquency is fairly low, rising to a peak delinquency rate often between years four and seven. The IRB approach implies that capital on newly originated residential mortgages should be lower at first and then increase with age. Yet, experience worldwide is that newly originated loans are indeed most vulnerable to economic downturns due to the lack of further equity build-up that more seasoned loans have accumulated. Consequently, a more stable capital approach would be to set the basis for expected losses on the peak loss years.

While actual performance data are likely to be the only data available for most banks in most countries, such data will likely be limited to the more recent years of

experience. This implies capital far lower than the current 50% weighting for prudent mortgages. The proposal attempts to address this anomaly by arguing that stress-testing would adjust capital for longer durations. However, the Basle 2 framework includes no specific requirement for stress-testing. Given the amount of work banks must do to implement the IRB, it is unlikely that many will also develop stress-testing at the same time. Without a specific stress-test mandate, many institutions will base their capital only on an insufficient amount of data collated during a period of unprecedented economic growth in many of the G-10 nations. Further, a failure to stress-test may well result in over-favorable capital treatment for unseasoned mortgage loans. While these are generally less risky than loans in the higher-probability-of default maturity band, this is not the case during periods of economic stress.

FIRST-LOSS TREATMENT REQUIRES REVISION

Finally, we believe that the Basle 2 proposal contains a technical error at paragraphs 207-212 in the Standardized Approach to Credit Risk paper. These paragraphs address the capital treatment for first-loss versus pari-passu positions. Despite the far greater risk protection afforded by first-loss CRM, the formulas result in the same risk weight in each case. As the Committee is aware, first loss coverage often eliminates any loss to the bank on a claim, whereas a bank with pari-passu coverage will incur at least some loss on all claims. To ensure proper relative weighting of first loss CRM versus pari-passu coverage, we recommend the following adjustments to the formulas:

- Add a term f to the first-loss coverage formula in paragraph 211 of the standardized model to reflect the deeper protection provided by first loss coverage. The current formula reads as follows:

$$E x r^* = (G_S) x r + G_J x [w x r + (1 - w) x g]$$

The formula we propose reduces the weight of the term dealing with the retained risk (G_S) to reflect the greater protection provided by first loss coverage. Where f equals the percentage of first loss coverage, the formula would read as follows:

$$E x r^* = [(G_S) x (1-f) x r] + G_J x [w x (1-f) x r + (1 - w) x g]$$

- Similarly, we recommend the formula for pari-passu coverage include a term p to reflect the fact the bank will incur a loss on any claim submitted, depending on the coverage level. The current formula for proportional coverage (paragraph 208, standardized model) is as follows:

$$E x r^* = (E - G_A) x r + G_A x [w x r + (1-w) x g]$$

The formula we propose adds a term p to address the proportion of exposure. Where p equals the proportion of pari-passu coverage, the formula would read as follows:

$$E x r^* = (E - G_A) x r + G_A x [(w + p) x r + [1 - (w + p)] x g]$$

MICA has calculated scenarios that clearly show a bank's losses on a \$1 billion pool of 90% LTV mortgages over a 15-year real-estate cycle would be 25% to 50% higher when proportional coverage is used instead of first-loss protection. MICA would be pleased to assist the Committee in any way as it works to finalize the Basle 2 proposal. We have extensive data on mortgage loan performance in the U.S. and other nations and we would be pleased to make this available as the Committee refines the treatment of mortgage risk in the standardized and IRB approaches.

Sincerely,

Suzanne C. Hutchinson

cc: Federal Reserve Board
 Basel 2001 Capital Proposal
 Federal Deposit Insurance Corp.