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Mortgage Insurance Trade Association
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May 31 2001

Madame Danielle Nouy
Secretary
Basel Committee on Banking Supervision
Bank for International Settlements
CH 4002
Basle, Switzerland.

Dear Madame Nouy,

Doubtless, the responses to the second consultative document are overwhelming in number and length. With this in mind, we have kept this note brief. It is rather more in the way of a request for additional clarification in the final form of the Accord than a formal response with suggestions and commentary. It is also an abbreviated response to the request for further input into the treatment of retail exposures. We have conducted substantial research into the subjects discussed below, which we will make available to you if this is desired. We are, of course, prepared to meet with and assist the relevant working parties and groups in those areas where we have specific expertise – such as mortgage exposures, residential property values, and insurance.

In general, we are concerned that the position of insurance as a risk mitigant for banking exposures within the Accord is not well defined. Our membership have received numerous requests from banks as to our interpretation of the proposals and we find ourselves unable to respond other than very vaguely.

In particular we are concerned by the treatment of mortgages. In the US, Canada, Australia and the United Kingdom there are highly developed markets for mortgage products, all of which have some historic form of government sponsorship. These remain a key instrument of social policy. The central role of mortgages, and their distinct, and sometimes preferred, treatment extends well beyond the boundaries and influence of Anglo-Saxon banking. We might equally have cited illustrations from France or Germany or many other countries.

Residential property is also the principal form of security or collateral for loans to small business, which is itself a prime element in economic growth.

We have looked and found no instance in modern times where systemic instability was rooted in unsound mortgage banking – though there are obvious illustrations

where the move away from specialist mortgage lending to more unregulated banking was the cause of considerable instability and distress.

Where residential property is effectively the collateral, it is obvious that the loan to value is a key indicator. The default process however is driven by household incomes and these are more than anything a reflection of the state of a particular national economy. It is commonplace for analysts to look to the average loan to value of a bank's book, but this is unfortunately problematic as simple averages can be misleading. It is also evident that the housing requirements of the young can only be met with relatively high loan to value advances, as they have not had the time to save substantial capital sums. This practice is sound in that, even now, salaries and wages can be expected to increase with increasing maturity. Contrary to popular myth, rising house prices relative to nominal advances have little direct influence in the banking decision. Many house equity release contracts, such reversions, are however predicated upon the performance of house prices.

The solution in many countries to the difficulty of high loan to value advances in the new mortgage business book has been to use insurance as the risk mitigant. It can be shown that this is cost effective relative to market solutions, such as securitisation, from the standpoint of the borrower, whose interests are as much a matter of social welfare as systemic stability. The legal basis is well established and the process constitutes true risk transfer, to highly regulated institutions specifically designed to acquire and manage risk exposures. The reason that insurance is a more effective route than market solutions lies precisely in the ability of the insurance company to estimate, price and manage the possible future exposures and losses.

We have been told that the Committee has reservations over the timing of the payment of insurance claims, which we find surprising given the range of contract choice available. It is important to realise that though an insured bank may not have received the final claims payment under a traditional structure, the bank has in this intervening period a valid asset, its claim upon the insurer. It seems that the principal difficulty here is in fact a matter of accounting practice rather than a true problem of capital adequacy. Additionally, policies may be phrased such that the insurer pays immediately based upon the estimated realisation with subsequent adjustment of payments to the actual disposal values.

One point which has been largely omitted from the debate on disclosures and transparency is that an insurance policy is predicated upon the principal of utmost good faith in the disclosure of relevant information, in which regard it differs markedly from securities market solutions, where only public information and the principal of caveat emptor apply. In this regard, it may be seen as a better observer and indicator of risk exposure than markets, or the derivative and guarantee solutions. Further, it is now standard practice to offer either a choice of a policy of this type or a financial guarantee, under which the burden of due diligence falls upon the insurer as it would in a market context.

Finally, there has been much debate over the increased pro-cyclical nature of the proposed Accord. The use of insurance as a risk mitigant expressly reduces any such pro-cyclicality. While this is simply contingent capital, it is most importantly capital which is external to the banking sector and which was priced ex-ante to the events causing the capital demands.

As is always the case, there is considerable variation in the specific form of insurance risk mitigation which arises in the largest part from the historic search for efficient solutions to risk transfer and management. For the purpose of this submission, any advanced level of detail is probably superfluous and we have avoided it. In consideration of the final form of the Accord however, it is probably required for the avoidance of doubt and ambiguity. We stand prepared to contribute to your final discussions in our areas of expertise recognising that we share the objectives of the Accord and the Committee.

Yours faithfully.

Cornelius Keating,
Advisor,
Mortgage Insurance Trade Association.