CONSUMER MORTGAGE COALITION

July 31, 2003

Mr. Jaime Caruana
Chairman
c/o Secretariat
The Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel,
Switzerland

Re: Comments and Recommendations on the Basel II Credit Risk Capitalization Proposals as They Affect the Residential Mortgage Business

Dear Mr. Chairman:

On April 29, 2003 the Basel Committee on Banking Supervision of the Bank for International Settlements issued a document entitled "Consultative Document of the New Basel Capital Accord" (also referred to as Consultative Paper 3 or "CP3"). The Committee requested comment by July 31, 2003.

The Consumer Mortgage Coalition, a trade association of national residential mortgage lenders, servicers, and service providers, is very pleased to have the opportunity to submit comments to the Committee. Our members include Chase Manhattan Mortgage Corporation, CitiMortgage, Inc., and Wells Fargo Home Mortgage, among others.

The Basel II Accord will significantly change the methods by which the amount of capital required for banks and financial holding companies is computed in relation to the credit risk of the various types of commercial and retail assets they hold. The proposed changes will also require capital to be held for operational and market risks. This comment letter concentrates on the credit risk capital requirements as they affect the residential mortgage business.

In our opinion, the net result of the changes delineated to date, as they affect the residential mortgage lending business, are generally favorable in that they align the amount of capital required more closely with economic reality. There are areas, however, requiring refinements and improvements. Specifically, the choice of a risk based capital

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method that includes Expected Loss (EL), but excludes or limits the use of Future Margin Income (FMI), the 10 percent minimum Loss Given Default (LGD) for "retail exposures secured by residential property" and, in that connection, the limitation of the benefit of private mortgage insurance (PMI) represent a layering of conservative choices that will cause economic distortions when combined.

For example, the 10% LGD floor discourages the use of PMI as a means of reducing an institution's credit exposure. Moreover, both the 10 percent minimum and the asset correlation factor for mortgages discourage purchases of mortgages that help make housing more affordable to low- and moderate-income families. The application of more economically accurate assumptions could mitigate this unfortunate result.

Although the Basel II Accord outlines three alternatives for the computation of Risk Weighted Assets (RWA), labeled as the Standardized, Foundation IRB, and Advanced IRB approaches in CP3, the U.S. regulators have determined in their Advance Notice of Proposed Rulemaking (ANPR) that only the Advanced IRB approach will apply in the United States for larger banks. Therefore, we will only address the Advanced IRB in this comment letter.

The Advanced Internal Ratings Based (A-IRB) method is based on each bank's internal assessment of key risk parameters to be input into formulas for deriving the RWA for each asset or asset group, and is expected to more closely align regulatory capital with a bank's concept of economic capital. The factors to be used in developing RWA under the A-IRB methods include: Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD). The A-IRB requires each bank to develop its own values for all such factors, subject to certain minimums and regulatory justification.

The Basel II Accord provides different rules and approaches to be applied as between commercial lending and retail lending, and within retail as among mortgage lending, credit card and other revolving lending, and other non-mortgage lending. These comments are addressed primarily to factors affecting the residential mortgage business.

1. <u>Exclude EL from the Capital Calculation</u>

We strongly recommend that the Committee align the Basel II Accord formula with best industry practice and require capital to cover only Unexpected Loss (UL) at the chosen confidence level, avoiding complications and potential inequities of FMI adjustments as well as issues related to the accounting of reserves. At the same time the Committee should modify its capital definition such that it includes the entire General Provision (GP) as capital without limitation, since the GP similarly protects against unforeseen losses. We believe that this approach would be more consistent with industry practice. In this regard we support the findings of Risk Management Association in their February 26, 2003 letter to the Federal Reserve Bank of New York.

If the Committee does not move toward an UL approach, we recommend that it make the necessary adjustments to more closely approximate an UL method. This would include applying FMI adjustments to residential mortgages and to all relevant product areas as a matter of principle. Mortgage loans are made on the basis of a thorough underwriting and appraisal, so the loan amount and terms are fixed from inception. Therefore, the FMI of mortgage loans is more predictable than credit card income, and should be allowed as a capital offset. The mortgage market employs advanced practices of risk based pricing across a wide spectrum of borrower credit so that FMI represents a real credit risk offset.

In addition, we request clarification of the statement that new accounts should be excluded in computing FMI. We assume that the exclusion applies to future accounts and not to accounts recently opened.

2. The Asset Correlation Factor is Too High for Residential Mortgages.

Asset correlation is intended to capture the degree to which defaults occur in unison, relative to economic events such as changes in interest rates, housing prices or recession. The Asset Correlation Factor (ACF) is central to calculating capital requirements and risk-weighted assets for residential mortgage exposures. The ACF value has been set at 15%, a value significantly above industry practice, especially for non-prime residential mortgages. This required high correlation for non-prime mortgages (with a higher PD) is inconsistent with treatment of other retail exposures. Furthermore, a recent U.S. Office of Federal Housing Enterprise Oversight working paper finds that while default rates are higher for non-prime borrowers, non-prime defaults are less responsive to homeowner equity than for prime borrowers.

3. The 10% Minimum LGD Factor Distorts Economic Incentives.

Under the A-IRB, banks are expected to compute the RWA value for each asset pool separately, utilizing the PD, LGD, and EAD factors based upon its internal evaluations of credit risk. In any mortgage business, these factors, particularly LGD, will differ based on lien status, prime versus non-prime, delinquency status, borrower credit score, loan to value ratio (LTV) at inception and at time of default, the amount of PMI where applicable and so forth. Presumably the bank will calculate separate factors for differing risk categories. The Committee, however, is proposing a uniform minimum LGD value of 10% "for retail exposures secured by residential property".

Many factors create LGD values much lower than 10% for specific residential mortgage loan portfolios. Conventional prime mortgage loans are typically originated with an 80% LTV ratio, which allows for a significant decrease in collateral value before generating any LGD. During the loan life, principal amortization has historically exceeded any value depreciation so that, even ignoring the historic trend of home value increases, the LTV ratio actually improves over time. Since the collateral is the borrower's home, with its corresponding psychological significance and economic importance to the borrower, a large percentage of home loans that enter default due to borrowers' temporary financial difficulties reinstate via a series of catch-up payments without any resulting loss.

Conventional loans written with higher than 80% initial LTV are typically further secured by PMI. In many cases this justifies an LGD expectation below 10%. PMI is a valuable tool, enabling banks to make loans at attractive rates to borrowers who have not accumulated a 20% down payment, without increasing risk to the bank. If PMI is not given its full value in decreasing the LGD factor, the bank is forced to choose between refusing to make the loan, or making the loan without the protection of the PMI and charging a higher rate to cover the increased EL. As a public policy matter, we assume regulators would encourage the use of PMI where appropriate to improve the banks' overall credit exposure while enabling low- and middle-income families to own homes.

The LGD minimum appears extremely high based on experiences and reasonable evaluations of mortgage lender portfolios, considering their underwriting standards, LTV ratios, use of PMI, etc., and inconsistent with the intended flexibility of the Basel II Accord. Floors on LGD should not be used to provide an additional redundant margin of safety. Instead, regulators should rely on other, more appropriate aspects of capital regulation to address such concerns.

4. Securitization Questions.

Paragraph 523 refers to the deduction of "interest-only strips receivable" from capital. We believe that this paragraph was intended to only refer to *credit enhancing* interest-only strips receivable. Servicing rights and other non-credit sensitive interest only strips are sometimes retained and capitalized. We would appreciate clarification that mortgage servicing rights, as well as non-credit-enhancing interest only strips (whether securitized or non-securitized), would not be subject to the capital deduction.

We also seek clarification of Paragraphs 513 and 524. Mortgage servicers periodically buy back loans from Ginnie Mae (GNMA) securities under GNMA's Early Pool Buy-Out Program. Such purchases neither create incremental credit support nor incur additional credit risk, so they should not trigger any punitive capital requirements. In addition, we would appreciate clarification that Paragraphs 513 and 524 would not be interpreted to cover contractual representations and warranties provided by sellers and servicers in securitizations.

Thank you for taking these comments and requests for clarification into account as the Basel Committee continues its important work of improving the alignment of capital standards with economic reality. If needed, we would be pleased to provide you with further information on the points that we have raised.

Sincerely,

Anne C. Canfield
Executive Director