



April 15, 2010

Secretariat
Basel Committee on Banking Supervision
Bank For International Settlements
CH-4002
Basel, Switzerland

Ladies and Gentlemen:

Genworth Financial, Inc. ("Genworth") is pleased to offer its comments in response to the Basel Committee's most recent consultative paper on "Strengthening the Resilience of the Banking Sector" (December, 2009).

Genworth is a specialty insurance company with assets of \$100 billion, based in Richmond, Virginia, USA and whose stock is listed on the New York Stock Exchange. Genworth offers life insurance, long term care insurance, wealth management services and is the largest globally active private sector provider of mortgage insurance (MI). MI provides protection (typically for the life of the loan and on a non-cancellable basis) to financial institutions against losses arising from borrower default on high loan-to-value (HLTV) residential mortgage loans, thus facilitating borrower access to such housing finance options while reinforcing prudent lending standards and supporting a more resilient and stable financial system. The focus of our submission relates to HLTV loans and MI as a credit risk mitigant (CRM).

Through our regulated subsidiaries or branches, Genworth offers mortgage insurance in the United States, Canada, Mexico, the United Kingdom, Ireland, Spain, Italy, Portugal, Sweden, Finland, Germany, Australia, and New Zealand. We provide such coverage to more than 1350 lenders in the United States, 200 lending institutions in Australia and New Zealand, 180 lenders in Canada, 90 lenders (with 27 currently actively originating new business) in member countries in the European Union, and 9 lenders in Mexico.

We believe our global experience with HLTV residential lending in a wide variety of markets, especially during several periods of severe economic stress, enables us to provide some unique and constructive input into how this economically important class of assets can be more prudently offered and the associated risk supported by appropriate capital in furtherance of the Committee's key goals.

Section I of our submission contains our comments and recommendations focusing on strengthening the treatment of residential mortgage risk, particularly for HLTV loans.

Our key recommendations are:

- A. Strengthen the regulatory capital treatment of residential mortgage loans**, particularly under the internal ratings based approach of Basel II to lessen the pro-cyclical incentives and tendencies inherent in the original Basel II Accord.
- B. Encourage bank regulators to more consistently and robustly incentivize the use of well regulated MI (and its equivalents) on HLTV residential loans** as an effective counter cyclical capital buffer, consistent with the Committee's goal of promoting a more resilient banking sector. We provide a specific methodology for IRB banks to do so in Section I.D at page 11.

Section II offers our initial suggestions and comments on implementing the Joint Forum's recommendations contained in its recent report (*The Joint Forum, Review of the Differentiated Nature and Scope of Financial Regulation, Key Issues and Recommendations (Jan. 2010)*) concerning the regulatory supervision of mortgage origination practices. We plan to provide more detailed suggestions to the Committee on how best to implement the Joint Forum's recommendations in a subsequent letter focused on the potential for issuance of "Sound Principles" guidance.

Appendix I provides more information, for those not fully familiar with its role, on the benefits that MI provides to financial system stability and market discipline.

Appendix II provides some detail on the differences between MI and other forms of credit risk transfer products such as credit derivatives and financial guarantee insurance. Genworth submits that MI is a unique form of credit risk transfer product which operates in a very different manner from credit derivatives and financial guarantee insurance, and so should be specifically excluded from any regulatory reform initiatives in this area.

We are confident that our recommendations would strengthen the capital of the banking sector and increase its resiliency by building appropriate and reliable capital buffers or "shock absorbers" into the system. They would also further more consistent treatment by banking regulators of a regulated, well capitalized and widely used credit risk mitigant that has a demonstrated history of functioning as a "shock absorber" against cyclical losses in the housing finance system.

We thank the Committee for its consideration of these recommendations and would be pleased to answer any questions concerning them or the data we present in support of them.

Very truly yours,



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**Genworth Financial, Inc. – Submission (16th April 2010) to the
Consultative Paper on Strengthening the Resilience of the Banking Sector**

IA. Strengthen Residential Mortgage Minimum Capital Requirements for HLTV Mortgages

Although the current Basel II minimum capital requirements cannot be said to be the cause of the crisis, recent experience demonstrates why modifications can and should be made to the capital requirements in order to better align risk and regulatory capital in a manner that would improve financial system stability and dampen pro-cyclical tendencies and incentives. The severe losses incurred in a number of countries resulting from poorly underwritten and mispriced residential mortgage loans have made it clear that regulatory capital for residential mortgage loans (what was thought to be among the least risky of asset classes) does indeed warrant a reassessment.

This has been especially the case in the US, the UK, Spain, and Ireland, but this recent experience echoes similar severe losses experienced on residential mortgage loans in past cycles in some of those and other markets.

Based on our experience with HLTV mortgage loans in a variety of markets, we believe there are several opportunities to strengthen the IRB formula, in particular, which if undertaken would better align regulatory capital with risk and would dampen procyclical tendencies and incentives. The key points are as follows:

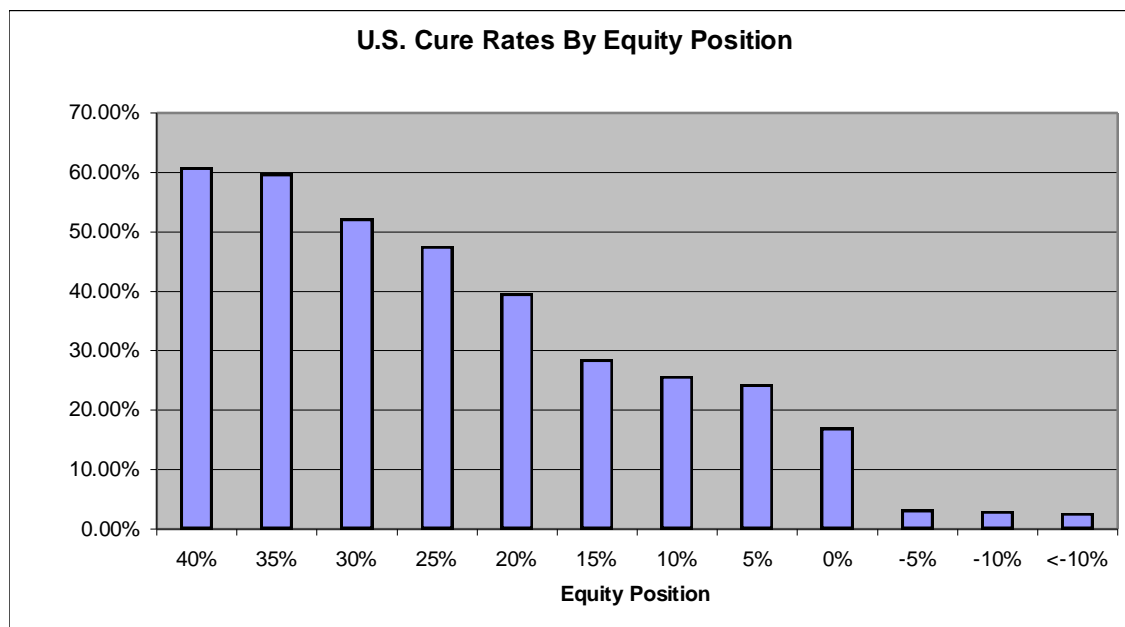
1. Treat HLTV mortgage loans as a separate asset class with a higher correlation factor consistent with available stress loss data;
2. Address the pro-cyclical elements of the IRB formula by
 - a) requiring the use of original LTV, adjusted for cumulative payments of principal, instead of allowing, as the current rules do, adjustments to the LTV based upon estimates of current market value – especially if done using a “market wide” house price index rather than a property-specific independent appraisal. LTV should also be determined based upon the combined loans secured by a property, taking into account any secondary mortgage loans on the property; and
 - b) specifying “through the cycle” versus “point in time” calculation of PD to reduce procyclicality;
3. Improve stress LGD estimates for HLTV loans by
 - a) using both the “expected” LGD and the “stress” LGD to calculate minimum capital, rather than specifying only the “stress” LGD in the retail IRB equation and
 - b) specifying a maximum recovery ratio on foreclosed properties rather than using an LGD floor;

4. Allow appropriate recognition of typical first loss percentage MI coverage, as opposed to proportional recognition on only the covered portion of the loan; and
5. Limit the use of behavioral scoring models in establishing regulatory capital for HLTV loans. While useful for forecasting expected losses for reserving purposes, such scores have proven not to be accurate in forecasting performance under stress conditions

A. Assign a Higher Correlation Factor to HLTV Loans

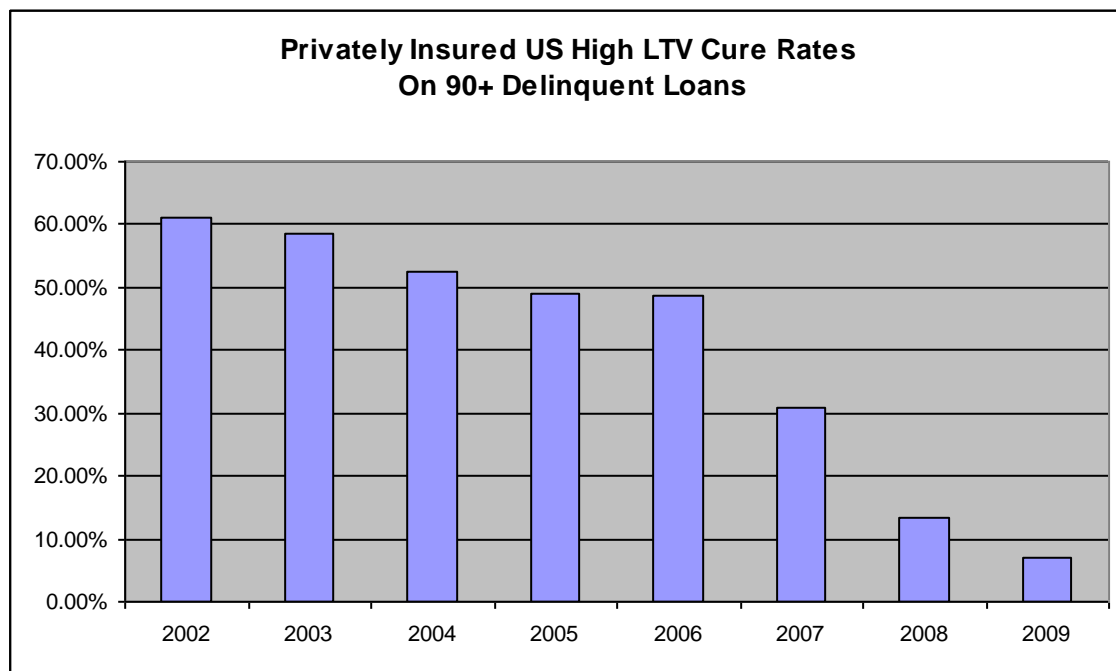
Because of the limited historical data available to many institutions, and especially performance data under a true stress in many parts of the world, the IRB treatment of HLTV risk could be modified to better reflect an additional significant behavioral characteristic that alters the response to economic stress of HLTV borrowers compared to low LTV borrowers. The IRB formulas assume that the relationship between stress conditions and expected conditions can be estimated using a single equation, using a differentiating correlation factor to adjust the results for certain asset classes that demonstrate specific response rates to stress changes. In the case of residential mortgage loans the single 15% correlation factor assumes that HLTV response rates will be similar to that of low LTV loans. The implied assumption is that the cure rates on all residential loans from 90 day delinquency status are the same, regardless of LTV or other segmentation. However, historical data suggests that under stress, the cure rates on 90 day delinquent HLTV loans can change drastically compared to the cure rates of delinquent low LTV loans, reflecting the loss of borrower net equity when there is a severe drop in property prices.

The U.S. mortgage insurance trade group pooled their information for the period of 1990 to 2002 to examine the cure rates of insured HLTV loans by net equity position at time of foreclosure. The results, shown in the chart below, reveal that small down payment loans are extremely vulnerable to changes in home values. Under stress, should net equity go negative on average, the cure rates fall below 5%. Equity positions of more than 20% enjoyed cure rates of 40% and higher. Essentially, assuming a typical stress test has a 30% decline in recovery value for these properties, borrower net equity on HLTV loans disappears and these assets perform more like an unsecured obligation.



Source: Special Compilation of Data From Four Major US Private MI Companies.

In the next graph, we show twelve month forward cure rates on 90 day delinquent U.S. privately insured HLTV mortgages. Between 2002 and 2006 US HLTV cure rates averaged 54%. But with the decline in home values beginning in 2007 and the consequent reductions in recovery ratios, HLTV cure rates on 90 day delinquencies fell to less than 7%, roughly 87% off the 2002-2006 average. At the same time, cure rates on low LTV loans have changed only marginally. Clearly, HLTV borrowers have a greater susceptibility to major changes in the market than other borrowers. This suggests two weaknesses in the IRB formula as it stands today: 1) that the rise in expected HLTV PDs to stress PDs are understated, and 2) the use of expected cure rates on HLTV loans may greatly underestimate stress HLTV LGDs. Lack of adequate cure rate data by original LTV segments in both good times and bad times make it difficult for banks and regulators to make bank specific estimates. However, if the Committee were to classify HLTV loans as a separate asset class with a separate, higher correlation factor, then the use of average cure rates could be effectively corrected for by the higher correlation factor. For the U.S. experience we have calculated that a 25% correlation factor provides an adequate correction. We recognize that default behavior in other markets may vary somewhat from the U.S. experience, but current experience does confirm that the basic drivers and patterns are the same.



Source: MICA Industry Historical Data Base

Based on the analysis and reasoning set out above, we recommend the Committee adopt a correlation factor between 20-25% for HLTV loans.

The proposed text is the following:

(i) Residential mortgage exposures

328. For exposures defined in paragraph 231 that are not in default and are secured or partly secured by residential mortgages, risk weights will be assigned based on the following formula:

Correlation (R) = 0.15 for those residential mortgages originated with loan-to-value equal or lower than 80%; and

Correlation (R) = 0.25 otherwise.

Capital requirement (K) = $\text{LGD} \times \text{N}[(1 - R)^{-0.5} \times G(\text{PD}) + (R / (1 - R))^{0.5} \times G(0.999)] - \text{PD} \times \text{LGD}$

Risk-weighted assets = $K \times 12.5 \times \text{EAD}$

The capital requirement (K) for a defaulted exposure is equal to the greater of zero and the difference between its LGD (described in paragraph 468) and the bank's best estimate of expected loss (described in paragraph 471). The risk-weighted asset amount for the defaulted exposure is the product of K, 12.5, and the EAD.

B. Address Pro-cyclical Elements in the IRB Formula

i) IRB Bank Models Should Incorporate and Combine Original LTV

For the reasons outlined below, Genworth recommends the Committee specify that banks incorporate original LTV, adjusted for actual reductions in principal outstanding, as the basis for segmentation and estimation of stress LGD in their models. There are three main reasons for promoting the use of original LTV as opposed to indexed or "current" LTV:

- the use of current LTV exacerbates the procyclicality of the IRB approach,
- index averages are not loan specific,
- and the predictive power of original LTV is stronger than current LTV.

Economic studies demonstrate that, in virtually every developed housing market, sharp declines in home values are almost always preceded by a prolonged period of unusually high home price appreciation. Under current Basel II IRB rules, lenders are incented to incorporate asset value changes into their models. These updated valuations are then used to reclassify the loans into lower LTV segments with LTV appropriate stress LGDs as well as lower PD estimates, thus reducing the regulatory capital allocated against them. In so doing, these valuation changes greatly lower capital requirements during housing booms, and then create enormous needs for capital when such values decline, reversing the reclassification. Use of original LTV would provide for a more stable capital requirement.

HLTV borrowers tend to be different from most other borrowers in that they are generally first time homeowners with few additional resources beyond the small down-payment. In general, they purchase homes that are valued at or below the median value of most markets. While most housing indices attempt to represent the average value change across all homes within a market, not all spectrums of the market enjoy the same degree of appreciation as others. In addition, the "best" borrowers in the original cohort tend to "move up" or refinance to a lower LTV loan, thus introducing an element of adverse selection over time. As a consequence, the actual value of HLTV financed homes tends to lag

behind broad housing market indices over time. The use of index-based revaluations will tend to under-estimate such values, and ultimately result in less than prudent levels of capital.

While one might argue that value adjusted LTV is the better predictor of probability of default in either expected or unexpected losses, many financial institutions lack multi-cycle residential loan data limiting their ability to verify the accuracy of that assumption for their portfolios. Using US MI historical performance data, we can look back in time to observe how actual claims remaining as a percent of loans still outstanding by origination year have varied over time and compare these remaining claim rates with the index value adjusted LTVs at each point in time. The results while counter-intuitive are nevertheless factual.

In the table below we selected three origination years with ultimate claim rates approximating the long-run average ultimate average claim frequency rates by two LTV range groupings, 85.01 to 90 and 90.01 to 95 LTV. Current valuation LTVs were calculated using U.S. government issued historical Repeat Sales Indices. The table shows that, despite significant price appreciation in the early years, remaining claims as a percent of loans still outstanding remained surprisingly close to the ultimate observed claim rates consistent with the original LTV long-run average. For 1974 set of 95 LTV loans, unusually high price appreciation in the late 1970s and early 1980s ultimately pushed remaining claim rates down but only after the current LTV index had pushed the LTV to below 60%. These results clearly demonstrate the superior PD predictive power of original LTV over indexed current LTV.

		Originations	1	2	3	4	5	6
95 LTV Examples	1974 Originations	59,196	57,801	54,710	49,880	43,638	37,360	32,971
	Cumulative claims		24	534	1,210	1,677	1,980	2,112
	Claims remaining	2,622	2,598	2,088	1,412	945	642	510
	remaining as %	4.4%	4.5%	3.8%	2.8%	2.2%	1.7%	1.5%
	Current Value LTV	95	90	85	79	69	61	55
	1978 Originations	122,578	121,971	116,924	110,223	102,022	93,710	84,395
	Cumulative claims		14	199	688	1,147	1,639	2,147
	Claims remaining	5,805	5,791	5,606	5,117	4,658	4,166	3,658
	remaining as %	4.7%	4.7%	4.8%	4.6%	4.6%	4.4%	4.3%
	Current Value LTV	95	84	76	71	69	67	64
90 LTV Examples	1986 Originations	104,478	104,101	99,679	91,318	81,985	73,019	63,512
	Cumulative claims		11	140	636	1,303	1,943	2,563
	Claims remaining	4,791	4,780	4,651	4,155	3,488	2,848	2,228
	remaining as %	4.6%	4.6%	4.7%	4.6%	4.3%	3.9%	3.5%
	Current Value LTV	95	86	80	75	71	71	69
	1978 Originations	215,455	213,913	202,447	185,649	167,624	153,093	137,223
	Cumulative claims		6	94	418	785	1,255	1,852
	Claims remaining	5,126	5,120	5,032	4,708	4,341	3,871	3,274
	remaining as %	2.3%	2.4%	2.5%	2.5%	2.6%	2.5%	2.4%
	Current Value LTV	90	80	72	67	65	63	61
90 LTV Examples	1985 Originations	71,443	71,117	60,731	42,942	35,780	30,910	26,501
	Cumulative claims		3	50	315	647	954	1,184
	Claims remaining	2,018	2,015	1,968	1,703	1,371	1,064	834
	remaining as %	2.8%	2.8%	3.2%	4.0%	3.8%	3.4%	3.1%
	Current Value LTV	90	84	77	71	67	63	63
	1991 Originations	194,952	194,192	170,744	99,559	69,971	60,588	49,580
	Cumulative claims		16	104	588	1,505	2,387	3,351
	Claims remaining	5,576	5,560	5,472	4,988	4,071	3,189	2,225
	remaining as %	2.9%	2.9%	3.2%	5.0%	5.8%	5.3%	4.5%
	Current Value LTV	90	88	86	84	83	80	78

To the extent that market valuations do have an impact, it will be reflected in observed PDs, which would affect the through-the-cycle average PDs. Consequently, there should be no need to reclassify the loans into different “current LTV” segments. Therefore to reduce procyclicality and improve the predictive power of the IRB approach, Genworth recommends the Committee require banks to use original LTV, adjusted for actual reductions in principal outstanding, as the basis for segmentation and estimation of stress LGD.

It is also important to ensure that LTV calculations take into account the combined loan-to-value ratio when mortgages are structured into first, second and even third liens. Failing to do so will ignore critical risk factors and create capital incentives to regulatory arbitrage, as was evident in the United States in the run-up to the current mortgage-market crisis and as could well occur in other markets following implementation of the final Accord.

In the U.S., the charters of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, require use of CRM for loans with LTVs above eighty percent.¹ However, to evade this requirement, U.S. lenders began to structure loans with first liens they sold to a GSE and second liens retained on their balance sheet. These structured mortgages – often called “piggyback” loans – have proven to be highly risky and are now posing very profound risk throughout the U. S. financial system. Recent data have shown that these second liens are disproportionately risky, especially in the recent vintages largely created to evade the GSE charter requirements.² The underlying first liens related to these second liens are also disproportionately risky, as demonstrated in recent data from the GSEs.³

As a result, Genworth urges the Committee to require calculation of LTV on a combined basis that not only represents original LTV, but also all outstanding liens secured by the residence. Doing so will ensure appropriate calibration of risk-based capital to true risk and circumvent an opportunity for regulatory-capital arbitrage. The committee is all too familiar with the ability of institutions quickly to spot such opportunities – evident for example with regard to off-balance sheet obligations – and it thus should ensure that the rule as finalized now takes into account all future potential structuring opportunities resulting from failure in the final Accord to capture known risk.

ii) Banks Should Use Through-the-Cycle PD Estimates

The Committee has requested comment on PD estimates in paragraphs 33, 34 and others. While the example above suggests that probability of default may not generally move with changes in home prices in all cases, it does show that value changes that are significantly different from the long-run averages may cause changes in the PD. And it bears repeating that many major advances in home prices beyond long-run norms have been followed by rather severe market corrections. Consequently, the choice of “point in time” (PIT) estimation of PD over the use of “through –the-cycle”(TTC)

¹ 12 U.S.C. § 1717(b)(2) and 12 U.S.C. § 1454(a)(2) (2009).

² Standard & Poor's, *U.S. Closed-End Second-Lien RMBS Performance Update: January 2010* (Mar. 3, 2010). “As of the January 2010 distribution date, cumulative losses totaled 4.84%, 20.50%, 33.30%, and 35.63% of the original aggregate pool balances for the 2004, 2005, 2006, and 2007 vintages, respectively.”

³ The GSEs have recognized this risk in their past SEC reports. For example, in its 2008 10K Freddie Mac noted “an observed increase in delinquency rates and the percentage of single-family loans that transition from delinquency to foreclosure, with more significant increases concentrated in certain regions of the U.S. and for loans with second lien, third party financing.... Similarly, as of both December 31, 2008 and 2007, approximately 14% of loans in our single family mortgage portfolio had second lien, third party financing at origination; however, we estimate as of December 31, 2008, that these loans comprise more than 25% of our delinquent loans, based on unpaid principal balances.” pp. 82 to 83.

estimation of PD, combined with updated value Stress LGDs, have demonstrated very negative effects on the stability of capital requirements. This is especially true over completed cycles. Although the Committee notes in paragraph 240 that national supervisors have the ability to apply through-the-cycle PDs, Genworth recommends that the Basel Committee strengthen this requirement to dampen the cyclicity of the international capital regime.

Insisting that banks use original LTV as the basis for segmentation and estimation of stress LGD and TTC calculations of PD will allow estimation of more stable capital requirements. This will better serve the housing market over the long-run and reinforce financial system stability. Moreover, moving away from required re-valuations in favor of original LTV removes additional expense from the process, permits more standardization of historical performance data for better modeling, and easier regulatory review and supervision.

C. Improve Stress LGD Estimates

i) Use Both Expected LGD and Stress LGD

The IRB calculation of minimum capital is an estimate of economic capital in that it uses the long-run expected PD and estimates a stress PD along with a stress LGD to estimate the difference between expected and “unexpected losses.” However, the current approach does not clearly specify the use of both a stress LGD and expected LGD in the IRB risk weight formula displayed below.

$$\{LGD * N[1-R]^{-0.5} * G(PD) + (R/(1-R))^{0.5} * G(0.999)\} - PD * LGD \} * 12.5 * 1.06$$

It appears many of the analyses being performed use only a single LGD which understates the true risk weight by a fairly significant amount. Therefore, we recommend that the Committee clearly specify the use of both a stress and an expected LGD estimate at appropriate points in the formula.

ii) Specify a Maximum Recovery Ratio for Estimating Stress LGDs in Place of LGD Floors

Because earlier quantitative impact study (QIS) reports revealed such low LGD estimates on several asset classes, and especially on residential mortgage classes, the Committee instituted an LGD floor of 10% for the first three years after implementation. Australia went a bit farther by requiring a 20% floor. The problem with a floor is that it has its largest impact on the truly lowest risk segments (e.g. low LTV loans) while doing very little to address under-estimation of LGDs on higher risk segments (e.g. high LTV loans), and discourage banks from seeking credit risk mitigation on these high risk assets.

Genworth believes that LGD floors misalign CRM incentives and capital for an important class of assets, and therefore recommends, based on our experience in a variety of markets, that the Committee specify use of a maximum recovery value ratio (i.e. net sales proceeds as a percentage of original valuation) for mortgage loans as a better alternative where such data is available. Our experience and data support utilizing a stress condition maximum recovery value ratio of 65%. This level is consistent with several U.S. regional recessions, but not as extreme as the 2009 U.S. national average recovery ratio of 60.4%. Moreover, the Reserve Board of New Zealand made a similar proposal stating that stress LGD's should be calculated using a maximum recovery ratio of 65% in order to better align risk by LTV to capital and to properly estimate the benefits of CRM.

With regard to the estimation of stress LGDs, in order to promote greater uniformity between large bank portfolios we believe that a set maximum stress recovery ratio on residential properties should be determined at the country level and is preferable to the use of LGD floors. In the table below we employ the use of a 65% maximum recovery ratio on all foreclosed residential loans. We estimate stress LGD estimates in the same fashion as the expected LGD calculation except for the substitution of a maximum 65% recovery ratio.

Estimating Stress LGD By Original LTV Setting Recovery Rate To Maximum 65%						
Original LTV	100	95	90	85	80	75
Mtg Coupon Rate	6%	6%	6%	6%	6%	6%
Months Til Disposition	18	18	18	18	18	18
Foreclosure Costs	5%	5%	5%	5%	5%	5%
Balance Due + Costs	114	108.3	102.6	96.9	91.2	85.5
Maximum Recovery Rate	65%	65%	65%	65%	65%	65%
Estimated Loss	49%	43.3%	37.6%	31.9%	26.2%	20.5%
Est.Loss As % Balance	49%	45.6%	41.8%	37.5%	32.8%	27.3%
Cure Rate (1999-2007)	45%	52%	56%	60%	62%	65%
Est LGD	27.0%	21.9%	18.4%	15.0%	12.4%	9.6%
With 2009 Stress Cure Rates Affecting The Stress LGD						
2009 Stress Cure Rates	1.4%	4.3%	9.9%	14.9%	50.0%	55.0%
Stress LGD	48.3%	43.6%	37.6%	31.9%	16.4%	12.3%

We have set forth additional supporting data analysis in Appendix III.

D. Recognize the Benefits of First Loss MI Coverage

For those regulators not familiar with less than 100% first loss MI loss protection, and how such coverage benefits bank policyholders, this section of the comment letter builds upon the LGD work provided above to account for MI benefits of varying percentage coverage. In the tables below we calculate the expected and stress LGDs net of MI benefits assuming full credit recognition.

	1999-2007 Avg Recovery Rate				Setting Recovery Rate To Maximum 65%			
Original LTV	100	95	90	85	100	95	90	85
Mtg Coupon Rate	6%	6%	6%	6%	6%	6%	6%	6%
Months Til Disposition	18	18	18	18	18	18	18	18
Foreclosure Costs	5%	5%	5%	5%	5%	5%	5%	5%
Balance Due + Costs	114	108.3	102.6	96.9	114	108.3	102.6	96.9
Maximum Recovery Rate	82.5%	82.5%	82.5%	82.5%	65.0%	65.0%	65.0%	65.0%
Estimated Loss Severity	-31.5%	-25.8%	-20.1%	-14.4%	-49.0%	-43.3%	-37.6%	-31.9%
As % Of Loan Balance	-31.5%	-27.2%	-22.3%	-16.9%	-49.0%	-45.6%	-41.8%	-37.5%
MI Standard Coverage	35%	30%	25%	12%	35%	30%	25%	12%
MI Benefit (Actuarial Avg)	33.25	29.19	24.76	13.33	38.57	34.69	30.38	15.59
Net Loss Severity As % Bal	0%	0%	0%	1%	10%	9%	8%	19%
Cure Rate (1999-2007)	45%	52%	56%	60%	45%	52%	56%	60%
Est Stress LGD With MI	0%	0%	0%	0.5%	5.7%	4.4%	3.5%	7.7%
With 2009 Cure Rates Affecting The LGD								
2009 Cure Rates					1.4%	4.3%	9.9%	14.9%
Est Stress LGD With MI					10.3%	8.7%	7.2%	16.3%

In the example above we show how the higher percentage coverages on higher LTV loans can result in lower net stress LGDs. Clearly, LGD floors of 10% (20% in Australia) would have a very negative effect on the desirability of using credit risk mitigation.

Genworth recommends that the loss given default (LGD) formula for loans covered by mortgage insurance should reflect the benefit of MI by subtracting the amount of the MI benefit from the loan balance and other costs to the bank.

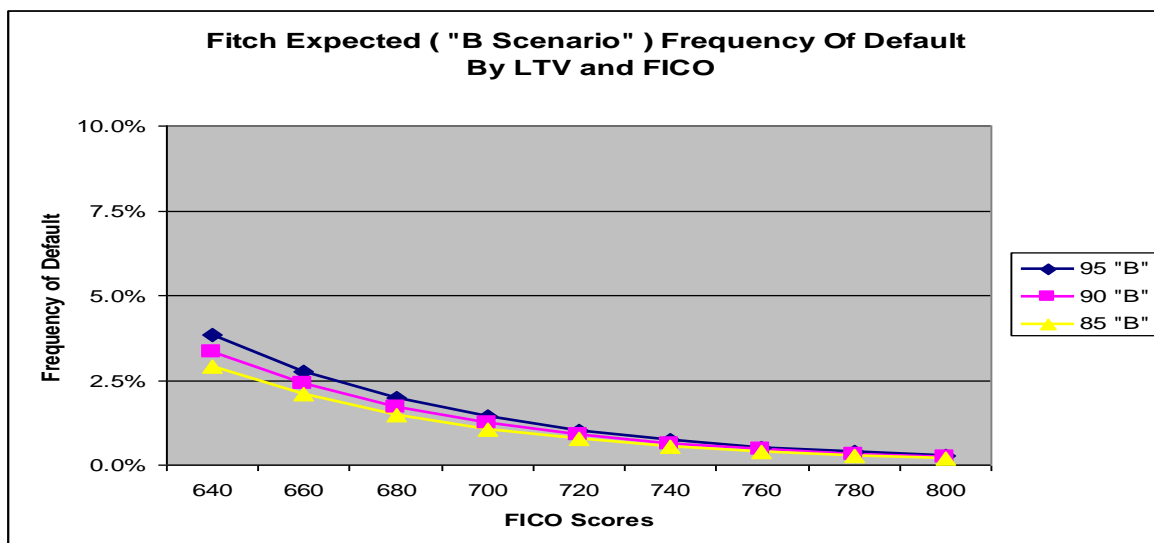
$$\text{LGDs} = (1 - \text{CRs}) \times ((\text{LB} + \text{FC} + \text{CC} - \text{RVs} - \text{MI}) \div \text{LB})^4$$

This revision to the LGD formula would provide a balanced and accurate assessment of MI coverage by reflecting its real-world effects on bank capital. Because the current formula fails to recognize the benefits of MI in the calculation of LGD, MI is effectively disincentivized in the capital rules.

E. Restrict Use Of Scoring Models For Regulatory Capital Estimation on HLTV Loans

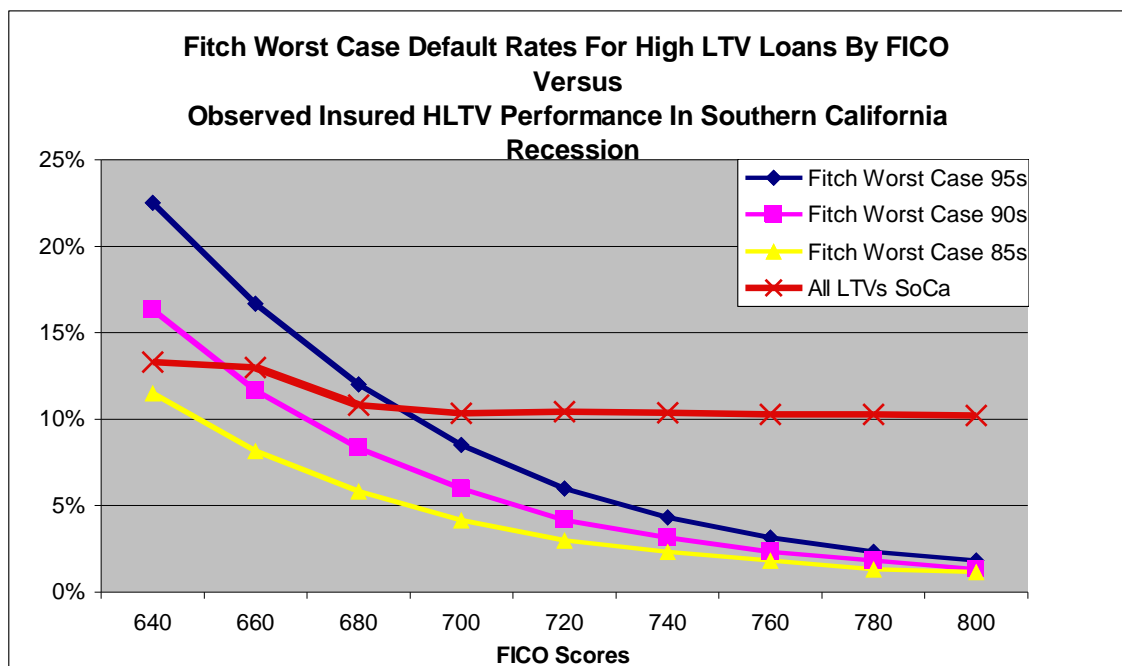
Scoring models for borrower credit have become a highly useful tool in estimating expected probabilities of default. Many banking and lending institutions and most mortgage insurers have developed their own models and use them extensively within their loss reserving approaches and underwriting. Nearly all of the models in use have been developed under benign economic conditions. As such, their effectiveness in predicting how well borrowers may perform under stress is limited. Several national regulators have voiced their concern about reliance on such scoring for capital purposes (including the Australian prudential regulator and the Spanish regulatory authority). We concur and offer the data below on HLTV loan performance under stress conditions segmented by FICO score and original LTV range. This data demonstrate that high score, HLTV loans default under stress conditions at a substantially higher rate than the typical scoring models would predict. Therefore, unless the scoring model includes robust data from a severe economic stress, Genworth recommends that the Committee limit the use of such scores in estimating regulatory capital for HLTV loans. As indicated above, Original LTV remains a more reliable basis for such calculations, is readily available and has the added benefit of simplifying the supervision of bank estimation processes.

Under normal conditions expected frequencies of default grow lower as FICO scores get higher. This can be seen in the graph below depicting Fitch rating agency assumptions published in 2001 on HLTV loans by FICO score. Genworth's experience for loans originated between 1996 and 2004 mirrors these expected case frequencies.



⁴ Where "LGDs" is stress loss given default, "CRs" is stress cure rate, "LB" is loan balance, "FC" is foreclosure costs, "CC" is cost of carry until sale of property, "RVs" is stress recovery value, and "MI" is MI coverage benefits.

The Fitch report also contained its worst case frequency assumptions by LTV Segment and FICO score and these are set forth in the graph below.

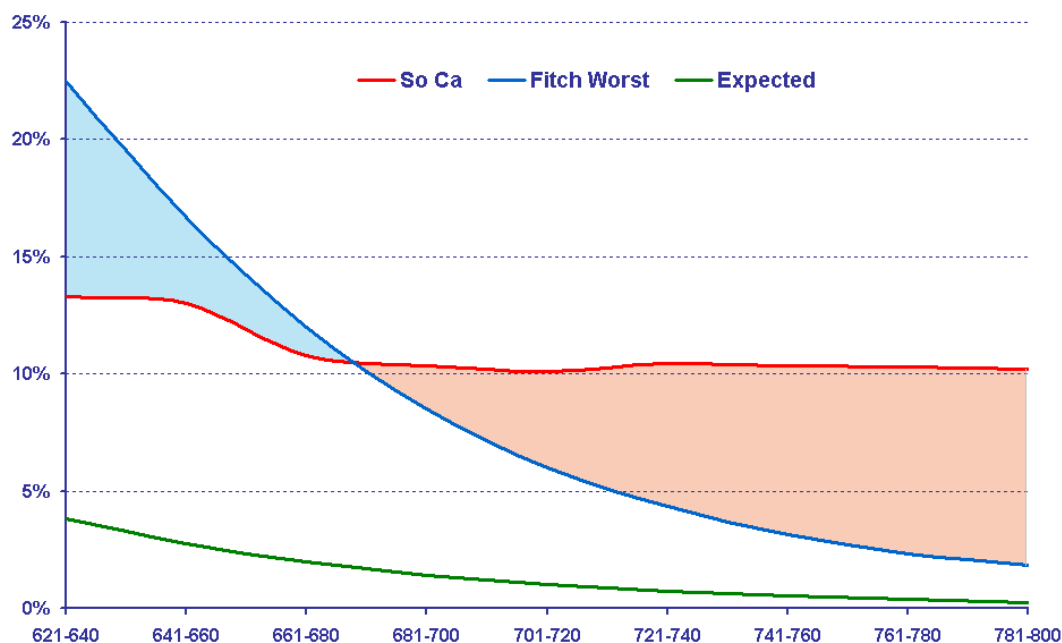


Unfortunately, Fitch did not have access to FICO score information on borrowers under true stress circumstances. Four US mortgage insurers did have such information on loans insured in southern California in the early 1990s, a period of severe stress for that market. Analysis of this pooled data revealed surprising results. Under stress conditions, higher scores correlated with lower frequencies of default, however there were no significant improvements in default frequencies for HLTV borrowers with scores above 680. The general lack of equity due to the fall in resale home values at foreclosure, combined with rising unemployment, meant that prior credit history on HLTV loans was not a meaningful predictor of default. Under stress, the borrower's net equity position on such loans is the most powerful predictor.⁵

In Figure 5 below we compare 95 LTV default frequency differences between expected conditions and worst conditions as measured by both the Fitch AAA estimates and the actual Southern California observations. For the sake of simplicity in this example we have only differentiated the results by PD, not LGD, even though stress LGDs would be higher. Thus the Fitch scoring estimates of relative economic capital are represented by the difference in the blue and green lines which show a sharp decline in economic capital as the scores go higher. In contrast, the observed Southern California relative economic capital segmented by score shows a rather unchanging amount of capital required. The shaded area reflects the difference in the two estimates, clearly demonstrating that actual economic capital by score is increasingly under-estimated as the scores go higher.

⁵ While our example stress situation is for non-recourse market as opposed to most global markets that can pursue the borrower, these results are likely to be similar for all markets for HLTV borrowers. This is because most borrowers using HTV financing are generally first-time homebuyers with little in the way of additional resources. Consequently, under stress situations the rise in unemployment and loss of net equity leave HLTV borrowers with fewer options to either cure or refinance their way out of serious delinquency, regardless of the recourse nature of the market.

Figure 5. Frequency Effects On Economic Capital: Fitch Score-based Model Vs. Southern California Recession



Contrary to the Fitch assumption that high score HLTV loans do not require as much economic capital, an actual stress experience demonstrates that scores are not a reliable indicator of losses under economic stress for HLTV borrowers. Moreover, the under-estimation of capital is greatest for the highest score borrowers. Additionally, using the average PDs associated with similar FICO by LTV segments the IRB framework produces overly small capital requirements for the highest FICO segments. Unless the models incorporate the performance of high score borrowers under actual stress, such scoring approaches would severely underestimate the true level of capital required.

Therefore, Genworth recommends that the Basel Committee limit the use of scoring models for the calculation of minimum regulatory capital on HLTV mortgage loans.

IB. Recognize and Incentivize Regulated, Well Capitalized Mortgage Insurance; Provide for More Consistent Treatment Globally

MI or its equivalent as a guarantee is a feature in the housing finance systems of about 30 countries. It is offered both by public sector entities and, increasingly, by private sector players such as Genworth. For example, the United States, Canada and Australia mortgage markets make extensive use of well capitalized and well regulated private mortgage insurance, having initiated the function in the public sector through the Federal Housing Administration (U.S.); Canada Mortgage and Housing Corporation (Canada) and Housing Loan Insurance Corporation (Australia). Similar public or private sector programs are in place and utilized in the United Kingdom, Ireland, Spain, Italy, Portugal, Sweden, Germany, France, Mexico, Hong Kong, Israel, Finland, the Netherlands, the Dominican Republic, Japan, the Philippines, Morocco, Guatemala, Estonia, Lithuania, Kazakhstan, the Palestinian territories, Serbia, Algeria, Mali and South Africa.

We wish to highlight to the Committee that several large developing markets, specifically India, Brazil Russia and China, are either taking steps to implement mortgage insurance- or functionally similar mortgage guaranty- programs (India⁶, through a venture sponsored by the National Housing Bank), or are actively considering doing so (Brazil⁷, Russia, and China).

We acknowledge that all of the products offered in each of the programs or by all private sector competitors are equally well regulated and capitalized, but that the prevalence of such programs should be reflected in consistent treatment as a CRM pursuant to explicit guidance by the Committee.

We also believe it is worth noting that HLTV lending reflects widespread and longstanding political and social objectives of ensuring that the financial system adequately serves moderate income borrowers... especially younger families who are first time homebuyers. These political and social pressures exist as well in large developing markets, and have not diminished even in well served markets. HLTV loans represent about 40% of the mortgage loans originated in Canada, about 35% of new loans in the United States and approximately 25% of loans originated in Australia. Any effective regulatory scheme must effectively deal with these higher risk assets. Mortgage insurance, where effectively regulated and well capitalized for the nature of the risk involved, is designed to be a capital buffer or “shock absorber” whose tangible, diversified capital base can be applied across the banking system wherever losses emerge.

For all these reasons, and those set forth in more detail below, we **believe that it is appropriate for the Basel Committee to promote a more internationally consistent approach to the recognition of well-capitalized, regulated MI**

In fact, a critical aspect of the Joint Forum’s report refers to such benefits of mortgage insurance and states that:

“Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including

⁶ <http://www.business-standard.com/india/storypage.php?autono=313965>

⁷ http://www.bcb.gov.br/pre/evento/resumoEvento.asp?evento=101&data=2010_3_101&id=inthouseconf2010

creditworthiness and reserve requirements), and should take steps to require adequate mortgage insurance in instances of high LTV lending (e.g. greater than 80 percent LTV). ”⁸

Genworth endorses and agrees with the Joint Forum’s recommendation that global regulators and supervisors should recommend mortgage insurance in instances of HLTV lending, and the broader role that mortgage insurance plays in achieving prudent housing policy goals by Governments.

A. Remove Minimum Rating Requirement for CRM Recognition

In addition, we agree with the proposal on to remove the minimum rating required for Credit Risk Mitigation (CRM) techniques and their providers. We believe that regulators should incentivize the use of well regulated MI (and its equivalents) on HLTV residential loans. We believe that it is far more meaningful to rely on the regulatory capital requirements and supervision imposed by national regulators to satisfy the requirement that they be a reliable counterparty risk, instead of relying on the rating attributed to them by rating agencies. The ratings based approach has proven to be flawed and outside the effective oversight of prudential supervisors.

B. Mortgage Insurance Provides a Fungible and Countercyclical Capital Buffer

Mortgage default losses almost never occur uniformly across national economies. There are almost always geographic regions or individual lenders that are disproportionately affected due to a variety of local economic conditions, especially in terms of regional disparities in unemployment, or as a result of different lender origination, underwriting and servicing strategies and capabilities. Consequently, when the capital requirements are established for residential mortgage lending based on market-wide loss experiences, the capital requirement will not match, and may be too low for, the distribution of actual individual bank performance.

For instance, requiring all banks to retain a level of capital for mortgage loss sufficient to handle the highest level of stress would result in an inefficient deployment of capital and increased operating expense that unfairly penalizes both lenders and borrowers alike. If, on the other hand, capital levels are set to a market-wide average and where actual losses exceed expected stress losses at some banks, insufficient capital requirements fail their intended purpose of shielding an institution – and the financial system – against destabilizing losses.

In comparison, mortgage insurance has two features which make it both more efficient and more effective at reinforcing the resiliency of the financial system. First, mortgage insurers provide coverage for a number of lenders, across regional geographies and for a variety of loan programs and origination systems, diversifying the risk profile across those market elements. Secondly, the MI capital is not anchored to any specific lender – it is fungible – and can be deployed where unexpected losses actually occur. In fact, historical mortgage insurance data – under both normal and stress conditions – demonstrate that the majority of claims payments are disproportionately paid to certain lenders, and often relate to properties in geographically concentrations (e.g. southern Spain, or southeastern United Kingdom). Mortgage insurance protection against such losses, as a result of its fungible quality, has proven to be a more efficient and effective capital buffer. (See the more detailed analysis and a specific stress loss case study below.) Moreover, the capital buffer provide by MI is meaningfully countercyclical in its impact. Premiums or fees are charged and accumulated as reserves or capital against the long-tail retained risk in the insured mortgage portfolios, increasing during strong

⁸ THE JOINT FORUM, *supra* at page 17,

economic cycles as volume and risk accumulate (offset by portfolio and risk run-off), and remain available, outside the banking system, to pay losses during periods of economic stress. Mortgage insurers operating under a single upfront premium model recognize or earn this premium over a longer term horizon (typically 9 or 10 years) in order to match the actuarially determined risk emergence pattern, with the unearned premium effectively quarantined on the balance sheet. In contrast, those mortgage insurers operating under a periodic premium business model are typically required to quarantine 50% of premiums in a contingency reserve for a period of up to ten years, with limitations around access to those funds. This business model ensures mortgage insurers have a longer term view of risk than the banking sector, which also serves to reinforce the countercyclical impact that MI offers.

As such, MI is designed to reinforce and achieve precisely the countercyclical and shock absorbing effect that the Committee is seeking to strengthen, and this should be strongly encouraged where it is available in well capitalized, regulated and reliable form.

In a paper published by the Federal Reserve Bank of Kansas City in August 2008 (“Rethinking Capital Regulation,” by Anil K. Kashyap, Raghuram G. Rajan and Jeremy C. Stein), the authors make essentially the same point; that banks be encouraged to protect against stress losses by purchasing insurance that functions like contingent capital that can drawn upon during periods of stress.

The current Basel II rules do not adequately address this need to adjust capital requirements to meet the different needs of banks, and the broader economy, during distinct periods of the economic cycle. But the authors point out that, requiring banks to hold such high capital requirements increases risks associated with poor governance and mismanagement, and that an insurance approach may be more efficient:

“In the case of a homeowner who faces a small probability of a storm that can cause \$500,000 of damage, the most efficient solution is not for the homeowner to keep \$500,000 in a cookie jar as an unconditional buffer stock – especially if, in a crude form of internal agency, the cookie jar is sometimes raised by the homeowner’s out-of-control children. Rather, the better approach is for the homeowner to buy an insurance policy that pays off only in the contingency when it is needed...Similarly, for a bank, it may be more efficient to arrange for a contingent capital infusion in the event of a crisis, rather than keep permanent idle (and hence agency prone) capital sitting on the balance sheet.”

Private mortgage insurance can effectively serve the role of this insurance policy for HLTV residential mortgage loans. Mortgage insurers are well suited to play this role from a broader systemic perspective because of their expertise managing HLTV residential mortgage risk and their clear incentive to curtail weak underwriting and other lending practices, given that they typically take a first loss position. Mortgage insurers also have a long-term view of residential mortgage risk, as well as a powerful incentive to ensure that premiums are set at an economically viable level to reflect long-term loss expectations. Finally, mortgage insurers build a reliable third party capital base which enables them to serve as critical “shock absorbers” or “capital buffers” to support banks’ losses during recessionary periods.

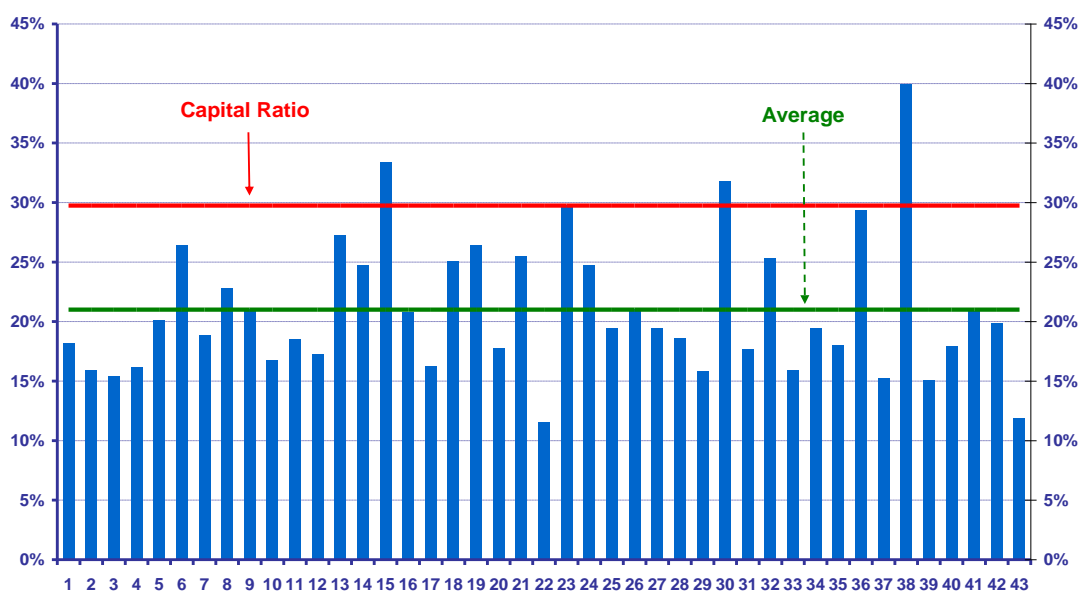
C. Concentration and Diversification Benefits of MI

One of the issues that many banking regulators have wrestled with is the issue of allowing a large proportion of bank asset risk being out-boarded to a small number of CRM providers. Their concern is that by allowing such a concentration of risk within the system, that the system as a whole is more

vulnerable in the event of a default by such entities. In Australia there are only two private mortgage insurance providers. In the US there are only six active private companies. In Canada there is only one active private company competing against a government sponsored enterprise. Mexico has one public and one private sector MI. The reason for the small number of players relative to the larger number of banks, is that diversification across banks is an essential element for the provision of true economic benefits to the financial system. Indeed, although we recognize active competition has benefits as well, from a pooling and diversification of risk perspective, the fewer the number of MI providers, the broader is the diversification across banks, and the greater is the economic benefit to the system. Naturally, in order for the system to remain well protected, the pricing, capitalization relative to risk, and investment restrictions of the MI companies needs to be configured in a manner that ensures the flow of default benefits especially in times of financial distress.

Many banking regulators do not fully recognize the diversification benefits of mortgage insurance. Many assume that under stress conditions, similar assets will perform essentially the same under such conditions for all banks. However this has simply not been the case. In a special study conducted by the US MI trade association, MICA, major MI companies combined their loan performance data from the Southern California Recession of 1989-1993. They also identified the institutions originating the loans in that market. Over 200 lenders supplied high LTV financing in that market over that time frame. The study found that what was most common between lenders was the average recovery value ratio, which meant that the LGDs by LTV were very similar. But what was different was the frequency of default. For smaller lenders such frequency differences were tied to the smaller numbers of loan originations and the laws of chance. However for the larger lenders, with larger volumes of origination, such differences were tied more directly to their individual underwriting and servicing practices.

The graph set forth below presents the frequency differences between the 43 largest lenders in that market at that time. The average default frequency for the entire market for 90 LTV loan originations was 20%, producing an average loss of 6.41%. If bank capital was set to cover losses up to 9.5%, three large lenders would still have had insufficient capital for the risk. Yet the MI companies paid all of the claims at an average of 6.41% because their capital was fungible across all of their bank customers. Bank capital is essentially siloed capital. The excess capital of one bank with lower frequencies cannot be used to pay claims for another suffering from higher than average frequency. Without the diversification benefit of MI, the banking system as a whole would need to hold substantially more capital than the MI companies to cover all losses. The difference in the capitalization required between the banks and the MI companies is the economic benefit. Lower overall capital means lower costs to borrowers.



Source: MICA

D. Provide More Consistent and Explicit Guidance on MI

We recognize that not all national mortgage insurance programs or providers may meet the appropriate criteria to be recognized as CRM. However, essentially comparable mortgage insurance protection is treated differently and inconsistently by national regulators. For instance, in their Basel 1A proposal US regulators proposed full recognition of first loss MI coverage essentially consistent with our recommendation. Japan's FSA declined to recognize comparable insurance coverage as a qualified CRM. Australia rules afford modest recognition for standardized banks, but no explicit recognition for IRB banks. We understand that the loan guarantee issued by the NHG in the Netherlands, the contractual terms of which are closely aligned to those in a typical MI policy, receive clear recognition under the existing Basel II rules.

While there certainly may exist some unique market or legal considerations, this wide variation in approach undermines cross-market and cross-sectoral consistency.

We believe the national bank supervisors should be encouraged to assess the reliability, transparency and adequacy of regulatory standards and supervision and, if satisfied that they exist and are appropriate to the nature of the risk being insured, grant Pillar I CRM recognition in the manner we've suggested in the next section.

E. Comparable CRM Recognition of MI in Minimum Regulatory Capital (Pillar I)

Because of the above mentioned strengths of mortgage insurance as a credit risk mitigant, Genworth recommends that the Basel Committee incentivize the use of MI by its favorable recognition in the minimum regulatory capital rules for IRB banks. Genworth urges the Basel Committee to revise paragraph 302 of the Accord to recognize insurance CRM on terms at least comparable to that of banks and securities firms because of the regulated, capitalized structure of MI and the policy benefits MI provides.

Indeed, the favorable treatment of securities firm CRM even applies to CDS or similar uncapped credit derivatives. As noted above, many of these products are fundamentally trading instruments, not

legitimate CRM and there is no regulatory requirement for all issuers of CDS to hold capital to honor their commitment. For example, U.S. broker-dealer securities firms are only subject to net capital requirements designed to ensure the execution of daily customer securities transactions, not long-term regulatory capital designed to handle credit risk. It is thus most unclear why securities firms should be granted equivalent treatment to sovereigns, PSEs and banks even as insurance companies – where regulatory capital is of course required to ensure claim-paying ability – are excluded.

Harmonized treatment of bank, insurance, and securities firm CRM by the Committee would contribute to the harmonization of financial-sector standards called for by the G-20 and the Joint Forum.⁹ As the Joint Forum report stated, “A sector-specific approach to supervision comes with the potential for increasing regulatory gaps, which causes supervisory challenges and presents opportunities for regulatory arbitrage.”¹⁰

F. Recommended Recognition of MI in the Proposed Leverage Requirement

Genworth notes that the Basel Committee has proposed the adoption of a leverage requirement as a supplement to the Basel II risk-based ratio. Genworth supports the goals of the leverage ratio in attempting to constrain the build up of excess leverage and provide a simple backstop measure of gross exposure. However, as proposed, the leverage standard would not recognize any CRM. Genworth believes that an accurate assessment of exposure should consider the coverage provided by mortgage insurance as effective credit risk mitigation.

We believe that it is critically important that the rules recognize the benefits of netting and true third-party guarantees on a bank’s true economic exposure. Public policy dictates that legally enforceable netting arrangements that are enforceable even in receivership or bankruptcy should be recognized under the capital rules. Further, first-loss guarantees provided by regulated, capitalized providers of credit risk mitigation should be deducted from the leverage requirement. Bank regulatory policy should strongly encourage the use of enforceable netting agreements, and one of the best ways to encourage the use of these arrangements would be through capital recognition of their benefits. This is similarly true of proven forms of credit risk mitigation like private mortgage insurance, and reflection of the value of these types of guarantees in the leverage requirement will enhance bank capital resources for additional lending in vital segments like residential mortgages without increasing bank risk.

Finally, we want to urge that any leverage ratio requirement should be appropriately calibrated so that it does not become the binding ratio for most financial institutions. If financial institutions are required to adjust their assets and activities to a binding, non-risk adjusted leverage ratio, the benefits of the risk-adjusted standard will be eliminated. Capital will no longer be a tool to control risk, but instead, under a binding leverage ratio, capital requirements will become an incentive to hold riskier assets. The leverage ratio should be viewed as a “backstop,” and not applied so as to become the “managed to” capital ratio for banking institutions.

⁹ G-20, Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, Final Report (Mar. 25, 2009), available at http://www.g20.org/Documents/g20_wg1_010409.pdf.

¹⁰ The Joint Forum *supra*, at page 3.

II. Implement The Joint Forum Recommendations for Improving Mortgage Underwriting and Originations

In January of this year, at the request of leaders of the 2009 G-20 Summit, The Joint Forum published a paper entitled “Review of the Differentiated Nature and Scope of Financial Regulation; Key Issues and Recommendations.” The purpose of the review and recommendations was to “identify potential areas where systemic risks may not be fully captured in the current regulatory framework and to make recommendations on needed improvements to strengthen regulation of the financial system.”

As outlined in the Joint Forum report, systemic risk can be reduced by ensuring properly underwritten mortgages and maintenance of origination standards that contribute to market stability:

Indeed, by focusing on prudent underwriting, supervisors can help institutions and markets avoid the broad-based issues and disruptions experienced in recent years and potentially help restore securitization/structured finance markets.”¹¹

By the fall of 2009, when the G-20 leaders gathered to assess, among other things, the fallout from the global financial crisis, it was clear that regulatory capital requirements, supervisory policies and the market conduct of financial service providers needed to be strengthened..

In addressing the issue of mortgage originations, the Joint Forum concluded that many mortgage loan originators were small to mid size companies that often operated without adequate regulatory oversight. They further noted that declining credit standards and easy access to third party sources of mortgage capital -- made available by a ballooning securitization market and erroneous risk analysis by rating agencies -- led to widespread lending to consumers who did not have the ability to repay the residential loan money they were borrowing. The Joint Forum took particular note of the fact that the supervision of mortgage originators across markets was widely disparate and, consequently, ineffective. The result was a widespread combination of both inferior underwriting and fraud – resulting in unprecedented mortgage defaults that undermined assumptions about the effectiveness of capital standards alone.

Put more explicitly, no matter how careful regulators are in establishing stronger minimum capital standards for mortgage lending, they will only achieve the desired level of effectiveness in preventing a repeat of the current crisis if the loan origination process is also regulated in a way that produces prudent lending practices and accurate and reliable loan data.

In the paper, the Joint Forum explicitly stated that it was not concerning itself with the issue of mortgage products, mortgage securitization or rating agencies since those matters were being handled concurrently by other initiatives and parent committees. What the Joint Forum focused on instead was the issue of mortgage originations – specifically underwriting practices and the regulation and supervision of mortgage originators.

¹¹ BIS, BCBS, THE JOINT FORUM, REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATION, KEY ISSUES AND RECOMMENDATIONS 15 (Jan. 2010), available at <http://www.bis.org/publ/joint24.pdf?noframes=1>.

The essential need for improved regulation and supervision of the mortgage origination processes was also made abundantly clear in a paper published by the Federal Reserve Bank of Cleveland in September 2009 (“Why Didn’t Canada’s Housing Market Go Bust,” by James MacGee). In this comparison of the U.S. and Canadian housing markets, the author demonstrates that both markets were subject to expansive monetary policies, similar economic conditions and substantial home price appreciation – but that Canada, unlike the United States, has successfully avoided a loan default crisis. The author concluded that a primary reason that Canada has not had widespread loan defaults is because it’s mandated mortgage insurance regime enabled the government to both strictly supervise and uniformly reduce credit risk through its ability to influence and even directly regulate mortgage underwriting standards.

Genworth Financial has had direct experience with these critical elements of prudent underwriting of mortgage risk. We observed in a number of markets the erosion of underwriting standards and the reduction in the reliability of loan data and witnessed the increasing market pressures to accept weaker credit and underwriting standards by both regulated and non-regulated originators alike.

Genworth would note that the experience of the mortgage-insurance industry demonstrates the value of our analytics and, thus, the regulatory and risk-management benefits resulting from capital and prudential recognition of MI. In the United States, the industry trade association, the Mortgage Insurance Companies of America (MICA), began to alert U.S. regulators to the growing mortgage-market crisis as early as 2002. MICA sought regulatory intervention in a wide array of venues in hopes of getting U.S. banking agencies to bar high-risk origination and securitization practices.

For example, the U.S. industry built on prior comments and urged the U.S. regulators in 2005 to block the simultaneous second liens (i.e., piggyback mortgages) that have now been a source of profound risk and loss to U.S. banks. MICA also wrote repeatedly to the bank regulators urging tough restrictions on non-traditional mortgages (e.g., no-documentation loans, those underwritten without regard to true debt-to-income ratios and other mortgage products structured in high-risk ways that undermine sustainable home ownership).¹² MICA noted, for example, the significant prudential and reputational risk resulting from bank origination of high-risk loans that are then sold into the private-label mortgage-backed securities (MBS) market, urging regulators to block banking organizations from high-risk originations to protect not just banks, but also the financial system more broadly.

Throughout this period of declining credit risk standards, Genworth and other MIs lost a substantial amount of market share in the United States market due to its unwillingness to insure many of these higher-risk products. At the same time, the mortgage insurance industry issued strong warnings to both regulators and rating agencies alike that several increasingly popular mortgage products could not possibly perform as well as issuers were projecting. See, for example letter dated September 5th, 2005 from the U.S. mortgage insurance trade association (MICA), containing a detailed analysis sent to and discussed with the key U.S. financial regulatory agencies.

This market feedback role of independent MIs is one that should be supported and encouraged. The erosion in the reliability of origination processes also opened the door to much more widespread fraud and misrepresentation on the part of both borrowers and loan originators. In retrospect, it’s now clear from a close examination of thousands of loan files that a large number of borrowers and originators,

¹² Mortgage Insurance Companies of America, letter dated March 29, 2006, submitted in comment on the proposed “Interagency Guidance on Nontraditional Mortgage Products” dated December 29, 2005 *available at* <http://www.fdic.gov/regulations/laws/federal/2005/05c45guide.pdf>.

often in collaboration, either fabricated or falsified the key elements of underwriting documentation and verification. It's also clear that the worst abuses were perpetrated by small, unregulated brokers rather than large, regulated institutions. The operational risks associated with fraudulent practices infected institutions on a larger scale than previously experienced. In the professional mortgage insurance industry, which has historically paid about 90-95 percent of its claims, the discovery of widespread loan fraud has also led to policy disputes and rescissions since the risk of fraud or misrepresentation, particularly on the part of loan origination personnel, is not the type of credit risk assumed under MI policies.

Rescission is fully appropriate under applicable contracts and necessary to ensure that lenders who participated in or tolerated fraudulent mortgage practice are at risk. Absent rescission, there would be no "skin in the game" for originators and MI would not serve as the effective form of CRM it has proven to be for both borrowers and banking organizations.

For these reasons, Genworth Financial place great emphasis on the Joint Forum's concern for the current lack of prudent and consistent mortgage underwriting standards and the fact that mortgage originators are often subject to a wide variance of supervision, regulation and enforcement levels. To "close the gaps," in regulation and supervision, the Joint Forum recommends, and Genworth fully supports, the following:

1. A requirement that regulators adopt minimum underwriting standards that focus on an accurate assessment of a borrower's ability to repay their loan obligation including effective income verification, reasonable debt-to-income limits, realistic qualifying mortgage payments, appropriate loan-to-value ratios, effective appraisal management, and a prohibition on the use of house appreciation in loan qualification. The Joint Forum also recommended that regulators take steps to require the use of mortgage insurance on high loan-to-value mortgages (LTV of greater than 80 percent) and enable lenders to retain full recourse to borrowers. (Joint Forum Recommendation No. 7).
2. Mandate that all mortgage originators, regardless of size or affiliation, be subject to consistent underwriting standards and oversight, as well as effective enforcement mechanisms. The Joint Forum recognized that in many countries regulators would need to obtain changes in their legal or supervisory regimes but nonetheless thought it was essential to correct current market failures. (Joint Forum Recommendation No. 8).
3. Stipulate that national policymakers should establish appropriate public disclosure of market-wide mortgage underwriting practices. Specifically, the Joint Forum recommended adequate public disclosure of market-wide trends and underwriting practices and that those disclosures be reviewed and evaluated from time to time by and international regulatory body. (Joint Forum Recommendation No. 9).

A. Establish Concentration Limits for Non-Conforming Mortgages

Genworth also believes that bank regulators should establish, as a matter of Pillar 2 bank supervision, concentration limits for mortgages that do not conform to the sound underwriting principles (similar to the U.S. interagency supervisory limits for mortgages that do not conform to the Real Estate Lending Standards).¹³ Because of the higher PDs and LGDs associated with these mortgages, supervisors should be sensitive to concentrations in these high risk products.

¹³ Interagency Guidelines for Real Estate Lending, 12 CFR 34, subpart D, appendix A (2009).

Specifically, Genworth recommends that the Basel Committee endorse a supervisory concentration limit to these non-conforming mortgages of 50 percent (or lower) of Tier 1 capital. Although the U.S. interagency guidance limits non-conforming mortgages to 100 percent of capital, Genworth believes that the U.S. experience has shown this level to be an ineffective concentration limit on banks holding these high-risk, high-LTV mortgages and not commensurate with the risks they can pose to bank capital.

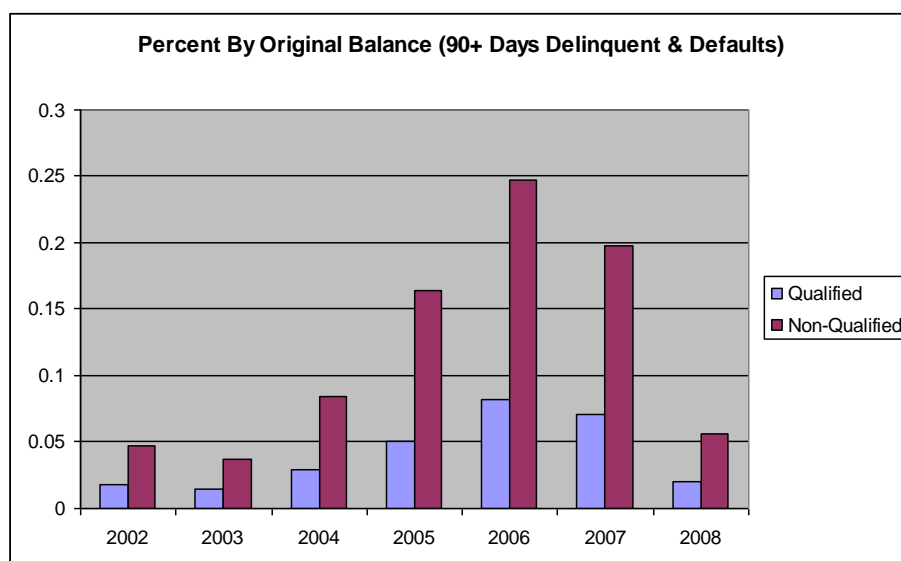
B. Benefits of Instituting Prudential Underwriting Guideline Standards

The recent Joint Forum comment letter regarding initiatives to strengthen the financial regulatory system included in their discussion the idea that the establishment of prudent underwriting standards would go a long way in reducing the volatility in financial markets. In order to test out such a theory, Genworth Financial sponsored a study by Vertical Capital Solutions working in conjunction with First American Core Logic. The study focused on the performance of two populations of conforming conventional loans (FHA and VA guaranteed loans were excluded from the study). The overall population of loans reviewed consisted of 37 million loans originated between 2002 and 2008. Qualified loans were defined as those loans underwritten as follows:

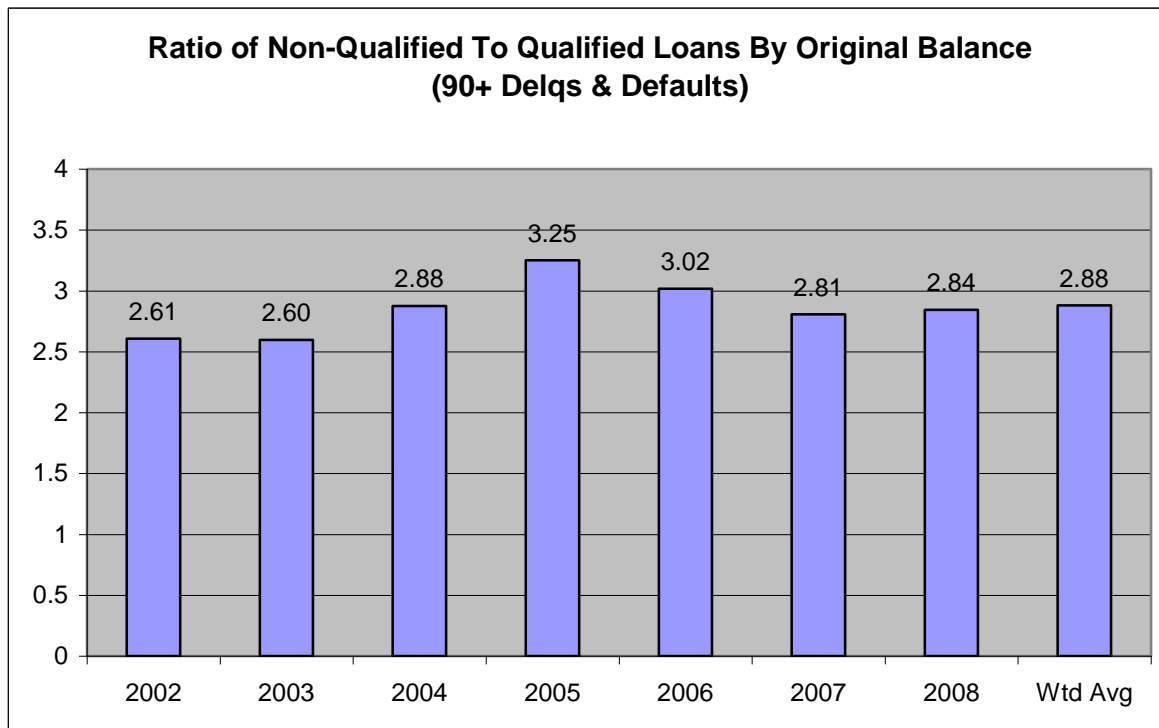
- 1) Full Documentation and Verification of all income, assets, and obligations
- 2) Debt-to-Income ratios of 41% or less
- 3) Terms of 360 months or less
- 4) No Balloon Payments
- 5) No Interest Only Payments
- 6) No Negative amortization
- 7) 7/1 Arms or greater
- 8) No Simultaneous Second Financing

Performance was measured in terms of ever-to-date actual foreclosures plus all loans delinquent 90 days or more at the end of our observation period (November 30, 2009). As a consequence, the following results displayed in the graphs below are completely factual, and are not estimates.

In the first graph, the results show performance differences by the two groups by year of origination. The first three origination years observed demonstrate results under mostly benign conditions, while the originations between 2005 and 2007 show the effects of the U.S. housing recession. Clearly in absolute terms, the non-qualified loans display considerably greater volatility than the loans under the qualified underwriting standards.



In the second graph the relative multiples of the non-qualified loan default frequency rates are compared to the qualified default frequency rates. In the first years, 2002 through 2004, the non-qualified multiples are roughly 2.6 times the default rates of qualified loans. However with the 2005 originations, the multiple jumps sharply to 3.25 times. The multiple then works its way back down to 2.8 times, with the average multiple over the entire period equal to 2.88 over the entire period. In essence, had U.S. regulators adopted such underwriting standards, with higher capital required on loans that did not meet such requirements, the U.S. housing recession may have been substantially less severe. This study and Genworth strongly support the Joint Forum call for prudent standard underwriting guidelines as a means for reducing the volatility in residential home loan performance, and thereby promoting greater stability in the banking and financial system.



Conclusion

We hope the foregoing analysis and recommendations are useful to the Committee in its endeavor to improve financial system stability. Our comments focus on a large and growing asset class held by the banking system, HLTV mortgage loans, one that has historically been subject to significantly greater volatility under stress than traditional mortgage loans. We have attempted to share with the Committee, along with as much as reliable data as available, our observations and experience with how this asset class performs under stressful conditions. We wish to emphasize that cyclical losses on HLTV mortgages have demonstrated a great propensity to “leak” into and affect adversely the broader economy, as defaults and foreclosures impact not just the bank holding these loans, but also put downward pressure on properties and borrowers in the same geographic area. Our goal has been to assist the Committee in identifying what refinements, particularly with respect to the IRB treatment of HLTV loans, will ensure that appropriate regulatory capital is aligned with this risk.

We sincerely appreciate the Committee’s consideration of this submission.

Appendix I. Financial System Benefits of Mortgage Insurance

As we noted above, HLTV lending comprises a significant portion of loans in many national markets, and is critical to affording moderate income and first-time homebuyer access to homeownership. MI exists and is used in many of those markets as a means of reconciling the goal of expanding access to those riskier segments of the population, with the goal of prudently recognizing, and allocating capital against, that increased risk thereby assumed within the financial system. These pressures and conflicting goals are unlikely to decrease. In fact, as noted, a number of large developing markets are moving to incorporate a mortgage guarantee or mortgage insurance function in their national housing finance system to enable the private banking system to prudently serve those market segments.

The MI function has built in incentives to take actions that reinforce elements of supervisory oversight, prudential regulatory policy, and market feedback and discipline. Some elements of that are set forth below.

I.A. MI Reinforces Enhanced Risk Management and Operational Disciplines

Mortgage insurance providers reinforce, from an independent perspective, important risk management disciplines in the housing finance sector.

- Typically, an MI and lender must review and agree upon credit policy parameters and loan underwriting criteria, such as acceptable debt-to-income ratio, borrower qualification standards for different loan programs and types, and what data elements will be collected and reported.
- MIs scrutinize and seek to develop and maintain a reliable property valuation process and a high quality borrower credit reporting.
- By deciding to accept or approve certain loan programs, products or lending criteria, MIs provide market feedback to bank management relating to their risk assessments.
- MIs typically require ongoing and comprehensive reporting of loan performance data used both for reserving and capital calculation purposes, but more importantly as an “early warning system” on the riskiest portion of residential mortgage.
- MIs, as discussed in more detail below, are incented to provide new and more effective methods of delinquency management and foreclosure avoidance.
- MIs provide market feedback to bank management through periodic audits of compliance with underwriting standards and agreed risk management processes.

I.B. MI Loss Mitigation

Because mortgage insurers are in a first loss position they are also the party at greatest risk from potential mortgage defaults. For this reason, the well-capitalized and well-regulated mortgage insurers are often the most sophisticated and successful providers of loss mitigation techniques, especially during periods of severe economic stress.

At Genworth, homeowner assistance for individuals in delinquency is an integral part of every insurance policy at no additional cost to the homeowner, lender or servicer. Unlike almost all other forms of credit enhancement, loss mitigation is embedded in all of our global operations and functions on a continuous basis, regardless of market conditions.

The primary goal of our loss mitigation efforts is to identify solutions that will keep borrowers in their homes and avoid foreclosure – and we have a proven record of success in this regard.

To “cure” loan delinquencies, we employ a wide range of tools, including financial counseling, loan modifications and, if necessary, debt forbearance and forgiveness.

We do an assessment of the potential for a loan workout by completely evaluating the borrowers obligations. Working together with lenders and servicers, Genworth searches for solutions with the greatest potential for success. Potential workouts are tailored to suit individual circumstances and financial challenges. Some examples of workout solutions that Genworth has arranged for borrowers include arranging partial loan payments, increasing the amortization period, deferring payments and arranging for voluntary conveyance.

In the United States, for instance, our MI business cured more than 20,000 delinquencies in 2009 alone, saving more than \$2.6 billion of mortgages from default. Equally as important, these substantial initiatives have reduced systemic pressures and contributed to home price stability.

For more on our global loss mitigation efforts, please visit the following sites:

<http://smartermi.com/homeowner-assistance.aspx> (U.S.)

<http://www.genworth.com.au/lenderresourcecentre/Forms/hardshipsolutions/index.htm> (Australia)

http://www.genworth.ca/content/genworth/ca/en/services/for_lenders/hoa.html (Canada)

I.C. MI Provides Supports Bank Liquidity in Periods of Stress

Under international accounting standards, delinquent loans covered by MI enable the lender to accrue an appropriate receivable reflecting the claim payment due under the policy coverage, thus supporting a bank’s balance sheet position. In addition, loans which have MI coverage, because of that third party CRM, are more easily valued and sold to third parties without a significant discount to reflect potential default losses

I.D. MI & The Proposed Risk Retention Requirements

In an effort to rein in the worst abuses of the originate-to-distribute model, bank regulators have pushed for originators to retain credit risk in mortgages sold into securitizations. The belief is that material risk-retention will be a check on deterioration in underwriting by requiring the originator to have capital at risk in the securitization. An unintended consequence of this risk-retention requirement will be a slower return of the secondary market, as originators are required to hold more capital against securitizations. Genworth believes that capital at risk is a key policy to ensure reform of the originate-to-distribute model, but it should be implemented with caution and reflect the positive role that third-party capital can play when placed at risk through mortgage insurance.

MI is required under applicable regulation to hold capital sufficient to meet commitments even under catastrophic-risk scenarios. MIs are subject by law in most regimes (e.g., the United States, Canada, Mexico, Australia) to uniquely strong reserve requirements that adds to the basic insurance capital standards since mortgage losses tend to concentrate during periods of high default rates. This counter-cyclical system has allowed mortgage insurers to build reserves during active periods of mortgage origination to be drawn on during times of stress in the market. The MI reserve effectively places third party capital at risk at origination, creating the same kinds of incentives for prudent underwriting that originator or securitizer risk retention does without unnecessarily constraining originator capital

during times of stress in the mortgage market. In fact, mortgage insurance meets the credit risk transfer (CRT) standards recently promulgated by the Joint Forum.¹⁴

Genworth recommends therefore that regulators should recognize and incentivize the positive role of MI as third-party capital at risk when considering risk retention requirements for securitizations and the CRM treatment of MI.

¹⁴ The Joint Forum *supra* at page 79.

Appendix II. MI Has Structural Advantages Over Financial Guarantors & CDS

Genworth believes that the Basel Committee should incentivize the use of regulated mortgage insurance and comparable products through more favorable recognition in the rules than other credit risk mitigation structures. Specifically, Genworth asks that the Basel Committee recognize the structural advantages of regulated MI over both credit default swaps (CDS) and pool-level financial guarantors (such as municipal bond insurers). Although these structural advantages come at a cost to regulated mortgage insurers, they allow regulated MI to ensure reliable risk mitigation, protecting both banks that are purchasers or investors in insured obligations and the financial system generally by reliable claims paying ability.

CDS are not insurance policies. CDS are derivatives contracts tied to the credit performance of an instrument and do not require the purchaser or have seller to an insurable interest. Although CDS were initially intended as credit-risk hedging instruments now, like other derivatives contracts, CDS are bought and sold by financial professionals who seek to profit from fluctuations in the market price of the instrument or to speculate on the occurrence of a credit event. CDS can therefore increase market volatility, as evidenced in recent sovereign-debt arenas, unlike MI which is not a traded instrument. As unregulated derivatives contracts, it is up to market participants to collateralize their commitments as sellers of CDS and sellers need not be regulated entities. Upon a credit event, CDS are most commonly cash settled against the market price of the reference instrument, although a voluntary auction process is commonly used for widely held instruments. As credit risk mitigation, CDS is inferior to MI because of the unregulated nature of the contracts, the use of unregulated counterparties, and reliance on market mechanisms to establish the level of credit protection at settlement. All of these factors create risks that are not present in mortgage insurance for regulated banks seeking to mitigate mortgage credit risk.

Until CDS are regulated, capitalized, prudently underwritten, and proven under stress, Genworth recommends that the Basel Committee should not permit banks to reduce risk-based capital on HLTV loans as a result of CDS or other derivative structures.

II.A. MI Relies Upon Underwriting at the Loan Level

Unlike bond insurance (and other pool-level financial guarantors), mortgage insurance is underwritten at the loan level. Mortgage insurers require the use of traditional risk-assessment underwriting criteria such as income verification, asset valuation, and credit history, effectively providing a second set of underwriting criteria for the mortgage loan in addition to those of the originating lender. Loan level analysis of borrower risk-characteristics is the most effective method for reliably pricing and provisioning for risk. Additionally, this second underwriting can help prevent a deterioration in underwriting standards as originators compete for market share and can catch loan processing mistakes made by originators, allowing mortgage insurers to play a critical Pillar III market discipline role in mortgage origination.

Bond insurance on structured mortgage finance products is underwritten at the pool level and is not required to assess the creditworthiness of the underlying loans in the pool. Representative samples may be taken, but bond insurers primarily rely on rating-agency statements, economic models and assumptions to estimate the performance of a pool of mortgages. These models are often unable to catch deteriorations in underwriting or errors in loan processing and are less accurate at predicting both the probability of default and the loss given default of a pool of loans than loan-level underwriting. Similarly, CDS contracts most commonly cover mortgage credit risk by reference to the performance

of mortgage backed securities and are also written at the pool level. Unlike bond insurance however, CDS are actively traded by speculators who believe that the current market misprices the true risk of these securities.

II.B. MI Prices for First Loss

Mortgage insurance is priced to cover the first loss when a loan defaults, completely protecting bank capital from losses until the coverage limit specified is met. This provides superior security to bank capital and other holders of credit risk, often eliminating losses to the bank, while *pari passu* structures, which only protect banks from a percentage of losses, will incur at least some loss on all claims.

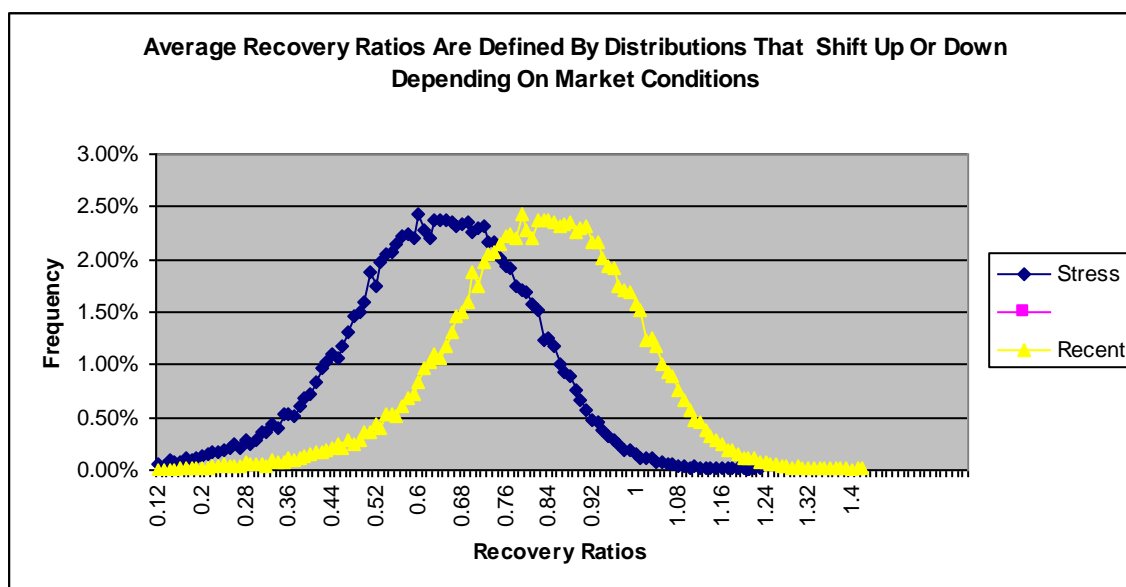
In sharp contrast to bond insurance, mortgage insurance under U.S. and many other national insurance-regulation regimes is capitalized to handle catastrophic mortgage related claims, pricing its product with the knowledge that it will have to provide first loss protection in the event of default. This increased pricing reflects the superior protection MI provides holders of credit risk, with actuarial and other techniques ensuring effective risk-based pricing that promotes strong credit risk mitigation. As noted above, CDS only cover mortgages within commonly-traded securitizations and do not provide the detailed loan-level pricing conducted by mortgage insurers.

II.C. Regulated MI Provides Protection Against Wrong-Way Risk

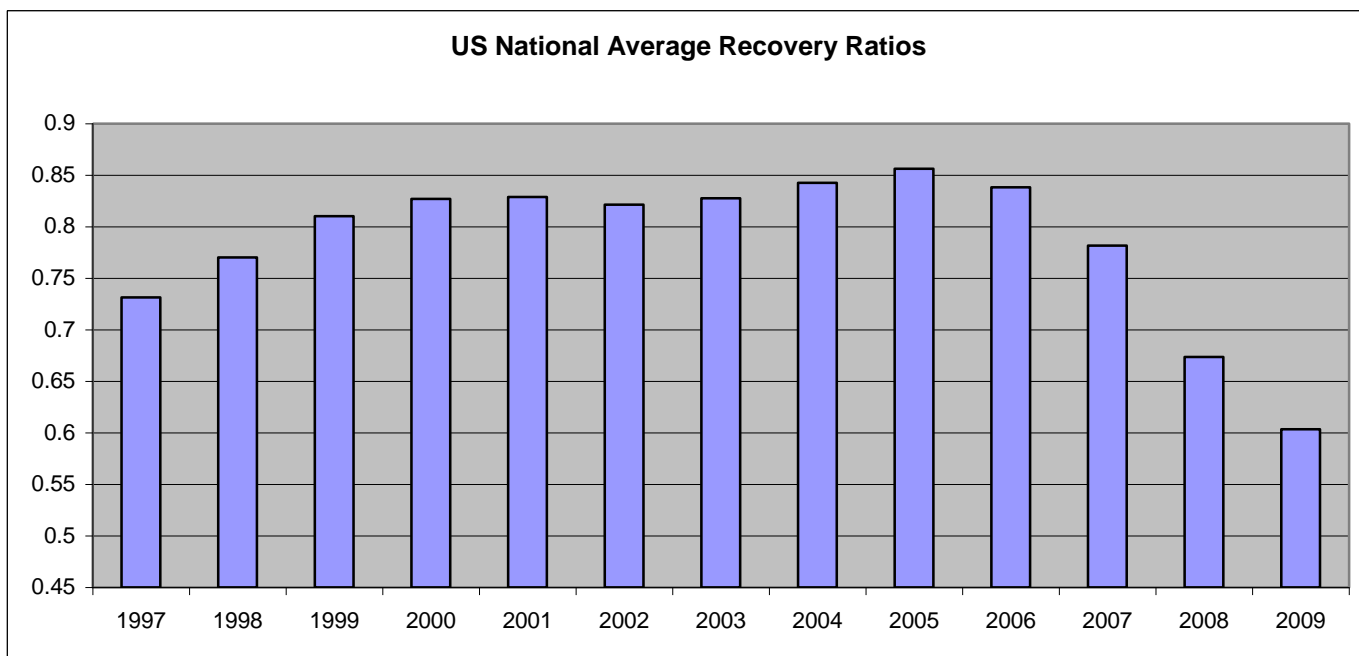
Genworth understands that recent experience related to municipal bond insurance has troubled global regulators as noted by the Committee in paragraph 129 of the consultative document. However, a critical difference between private mortgage insurance – which in the U.S., Canada, Australia, Mexico, India (mortgage guaranty regulations issued by the Reserve Bank of India), and a number of other countries must be provided in monoline companies – and bond insurance is that MI may not be associated with high-risk, non-traditional products. Bond insurers used “transformer” structures to put high-risk credit derivatives in affiliates outside their regulatory capital and prudential limits even though the bond insurer was actually liable for the risk. Mortgage insurers are prohibited from doing this. In addition, many bond insurers held capital in assets directly correlated with those of the non-traditional obligations for which they provided a financial guarantee, creating wrong-way risk. Thus, when a loss on an investment was realized by an investor and a claim was placed on the bond insurer, the bond insurer was likely to hold a comparable investment that increased its loss exposure and simultaneously reduced its capitalization. Mortgage insurance protects against wrong way risk through effective regulation of its capital holdings which are intended to and do limit correlation between assets and liabilities and preserve the ability of mortgage insurers to pay claims. Similarly, because CDS are unregulated and may be written by unregulated financial companies, there is nothing to prevent the creation of wrong way risk at sellers of CDS.

Appendix III. Maximum Recovery Ratio vs. LGD Floor- Supplemental Data

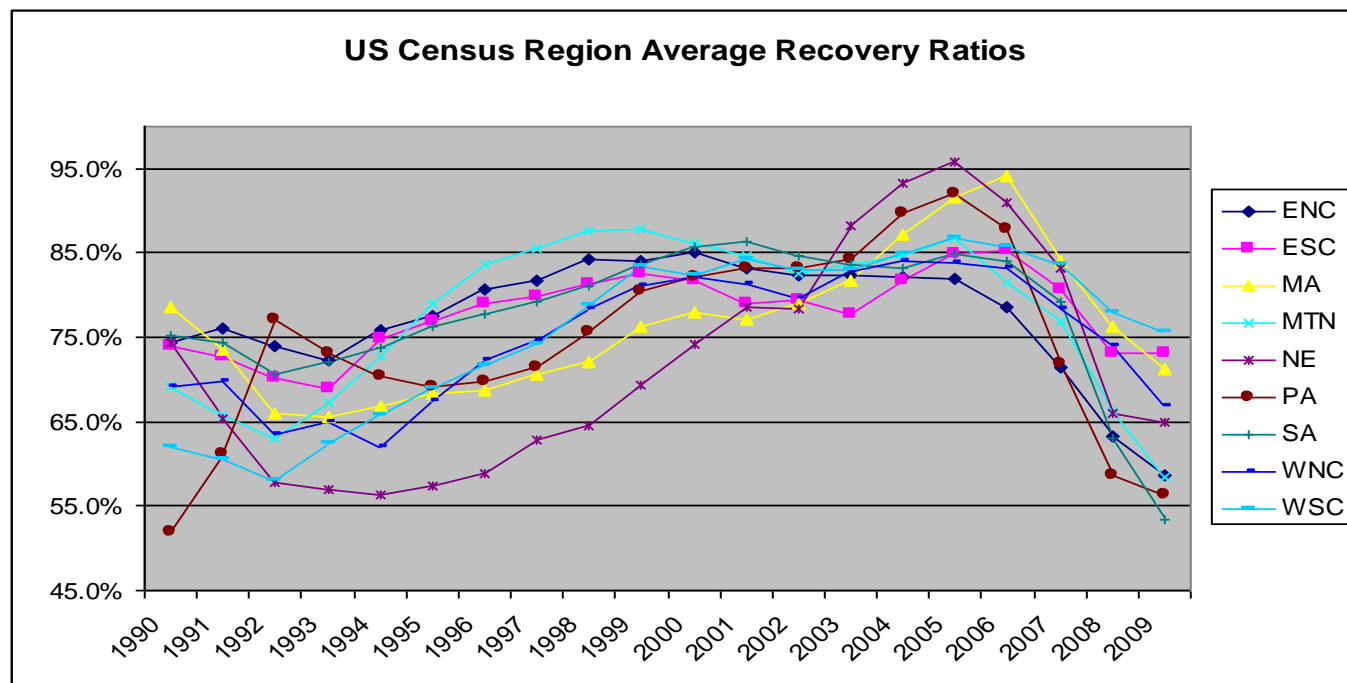
Continuing the discussion Section XX above, the most important element that should be considered is not the overall value of the properties relative to their loan balances, but rather what is the recovery ratio on loans that do go to foreclosure. More importantly, the process of estimating average losses requires that one consider the distribution of recovery ratios rather than the simple averages. In examining such distributions in Genworth's operations in Europe, USA, Canada, and Australia, we have found that they are normally distributed about their individual means, but that the standard deviation is roughly the same. It suggests that as markets either improve or weaken, the distribution moves accordingly up or down. When the distribution moves up, and greater proportion of the loans in default cure long before reaching the 90+ delinquency status, but leave a remaining distribution with an average recovery ratio that moves upward very begrudgingly.



In the charts below we show how recovery ratios have varied in the US both nationally and by Census region. From 1997 through the first half of 2006, the US average repeat sales index recorded home price appreciation well above the long-run average of 4% per year. The increasing equity positions of homes shifted recovery value ratios to higher levels with greater cure rates resulting in fewer defaulted loans going to foreclosure. Nevertheless, the part of the distribution not achieving sufficient market value to affect such cures had an average recovery ratio of 82.5% from 1997 through 2006. Over a similar period of time, Australia averaged 87%, supported not only by a robust economy, but a continued increase in immigration. Following the market liquidity crisis of 2006, US home price changes went negative in 2007, shifting the recovery ratio curves sharply lower. By 2009 the US national average recovery ratio had fallen from 84 % in 2006 to 60.5%.



The chart below displays average recovery ratios by US Census regions in order to reveal the range of recovery ratios in both robust circumstances and in stressful conditions. The ratios range from a high of 95% to lows below 60%.



In order to flesh out some of the concepts we have discussed thus far we have provided a series of example calculations to illustrate their implications. First of all, we want to calculate expected LGDs for various LTV segments to illustrate how the recovery value ratios can produce appropriate expected condition LGDs. In the example below we use the 1997-2006 average recovery ratio for the USA, as well as an assumed average mortgage coupon of 6%, and a 5% foreclosure costs. We have also utilized average one-year forward cure rates by LTV segment for the same period of time. For this exercise we use actual cure rate averages for HLTV loans and have estimated the cure rates for loans

with lower LTVs based on various estimates of Basel II discussions of the IRB framework. Note that HLTV borrowers had somewhat lower cure rates over this time frame.

1999-2007 Avg Recovery Rate						
Original LTV	100	95	90	85	80	75
Mtg Coupon Rate	6%	6%	6%	6%	6%	6%
Months Til Disposition	18	18	18	18	18	18
Foreclosure Costs	5%	5%	5%	5%	5%	5%
Balance Due + Costs	114	108.3	102.6	96.9	91.2	85.5
Average Recovery Rate	82.5%	82.5%	82.5%	82.5%	82.5%	82.5%
Estimated Loss	31.5%	25.8%	20.1%	14.4%	8.7%	3.0%
Est.Loss As % Balance	31.5%	27.2%	22.3%	16.9%	10.9%	4.0%
Cure Rate (1999-2007)	45%	52%	56%	60%	62%	65%
Est LGD	17.3%	13.0%	9.8%	6.8%	4.1%	1.4%

The higher the cure rate, the lower will be the estimated LGD given the loss severity for that segment. The lower the cure rate, the higher will be the estimated LGD. In general, the higher the original LTV the higher will be the estimated LGDs, both expected and unexpected.

With regards the estimation of stress LGDs, in order to promote greater uniformity between large bank portfolios we believe that a set maximum stress recovery ratio on residential properties should be determined at the country level and is preferable to the use of LGD floors. In the table below we employ the use of a 65% maximum recovery ratio on all foreclosed residential loans. We estimate stress LGD estimates in the same fashion as the expected LGD calculation except for the substitution of a maximum 65% recovery ratio.

Estimating Stress LGD By Original LTV Setting Recovery Rate To Maximum 65%						
Original LTV	100	95	90	85	80	75
Mtg Coupon Rate	6%	6%	6%	6%	6%	6%
Months Til Disposition	18	18	18	18	18	18
Foreclosure Costs	5%	5%	5%	5%	5%	5%
Balance Due + Costs	114	108.3	102.6	96.9	91.2	85.5
Maximum Recovery Rate	65%	65%	65%	65%	65%	65%
Estimated Loss	49%	43.3%	37.6%	31.9%	26.2%	20.5%
Est.Loss As % Balance	49%	45.6%	41.8%	37.5%	32.8%	27.3%
Cure Rate (1999-2007)	45%	52%	56%	60%	62%	65%
Est LGD	27.0%	21.9%	18.4%	15.0%	12.4%	9.6%
With 2009 Stress Cure Rates Affecting The Stress LGD						
2009 Stress Cure Rates	1.4%	4.3%	9.9%	14.9%	50.0%	55.0%
Stress LGD	48.3%	43.6%	37.6%	31.9%	16.4%	12.3%