Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

April 16, 2010

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

Ladies and Gentlemen:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the Basel Committee on Banking Supervision's latest consultative paper on "Strengthening the Resilience of the Banking Sector."[1] In this letter, we shall focus on aspects of the consultative paper affecting liquidity-risk management; a separate letter provides our views on the revisions proposed for global regulatory-capital standards.

MICA represents the interests of the United States private mortgage insurance (MI) industry, which currently has $850 billion of insurance in force on residential mortgages with high loan-to-value ratios in the United States. Although MICA's focus is on U.S. matters, we would note that MI is an important feature not only in the United States, but also in other developed and developing national mortgage markets. MICA has a keen interest in ensuring that bank lending and securitization practices in the residential-mortgage sector are prudent and support sustainable home ownership that protects borrowers, lenders, investors and communities.

Managing the funding and liquidity risks related to residential mortgage lending and securitization is vital to a long-term, stable mortgage market. Mortgages have maturities of as long as thirty years in which interest rates may not vary from the initial rate upon origination. As was all too evident in the savings-and-loan (S&L) debacle in the United States in the 1980s, poorly-managed funding mismatches in the mortgage sector can have profound systemic implications. Of course, overall ineffective liquidity-risk management

---

[1] Basel Committee on Banking Supervision [BCBS], *Strengthening the Resilience of the Banking Sector*, Consultative Document (December, 2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1.

1425 K Street, NW
Suite 210
Washington, DC 20005
(202) 682-2683
Fax (202) 842-9252

has played a major role in the current financial-market crisis, as rightly described in the consultative paper.

Based on this hard experience, MICA supports a stringent liquidity-risk management framework in global standards that ensures that consistent rules apply at the national level. Much in the consultative paper is appropriate, but we are concerned that the proposal is so prescriptive and comes at a time of so many other pending, tough new rules that the liquidity-risk standards could contribute to a sharp curtailment in global financial-intermediation activity. This would, of course, dampen economic recovery and prolong the recessions now gripping so many member nations participating in the Basel Committee.

To prevent this, MICA urges the Basel Committee to advance new liquidity-risk standards with care. Before finalizing new standards, the Committee should carefully calibrate the approach it seeks to require not only in terms of funding and liquidity-risk markets, but also in the context of the capital revisions. It should also ensure that the liquidity rules, like the new capital framework, appropriately rely on third parties to provide liquidity support, credit-risk protection and other backstops to enhance the resources of banking organizations to support credit formation. Although MI is principally a form of credit risk mitigation (CRM), it can also promote appropriate liquidity-risk management at banking organizations because MI pays valid claims and thus avoids a drain on bank resources under stressed situations where funding may not be adequate to handle unanticipated loss. MI should thus be factored into all relevant calculations of net cash inflow in the liquidity-risk requirements and treated as a reliable, high-quality source of funding capacity.

Specifically, MICA has the following comments on the liquidity consultative paper:

- MICA supports the thrust of the liquidity-risk standards and the positive impact they will have on curtailing structured, off-balance sheet instruments and similar activities that create systemic risk. As with the capital rules, liquidity standards should rely to the greatest extent possible on third-party support which, for liquidity purposes, means third party sources of net cash inflows that are themselves well-funded, capitalized and uncorrelated entities that can meet their claims under even catastrophic-risk scenarios. Recognition of such third-party cash sources will reduce the burden of the new liquidity rules on banking organizations, speeding implementation of a robust regime that will

strengthen global financial markets without imposing short-term constraints on financial markets adverse to economic recovery.

- Reflecting this, MI should be expressly recognized as a source of net cash inflow in the presentations of off-balance sheet (OBS) sources of contingent funding, especially with regard to the longer-term net stable funding ratio.

- MICA supports the new liquidity-risk standards for bank guarantees, which help to ensure that banks are not put at risk and that the overall financial system is strengthened with regard to off-balance sheet commitments. We concur that the rules should treat bank-affiliated entities in a manner comparable to unaffiliated ones as long as this reflects appropriate recognition of potential conflicts of interest.

- Regulators should modulate the liquidity-risk standards and implement them with care to ensure that bank rules are not so strict that financial services migrate to unregulated institutions or smaller banks left outside the standards for internationally-active institutions. Regulators should thus carefully calibrate the liquidity standards in conjunction with the pending capital rules and avoid still more requirements – e.g., risk retention related to asset securitization – as the reforms proposed in the entire consultative paper are finalized and implemented. Once the new capital and liquidity framework is in place and tested, regulators can determine if additional rules are still required, but a regulatory system of certain, clear standards should be well in place at that time to ensure markets recover without undue volatility or credit constraint.

It is our understanding that the Basel Committee, in conjunction with the International Organization of Securities Commissions (IOSCO), is working on draft principles to ensure appropriate asset securitization. MICA endorses this effort and looks forward to working with you to enhance global standards in this vital area. In promulgating these standards, MICA urges the Basel Committee to ensure appropriate coordination between securitization requirements and the capital, liquidity and other prudential standards now in development to ensure that all rules are appropriately calibrated and balanced to permit ongoing securitization that includes a vital role for private capital. Absent careful consideration of private capital, asset securitization -- especially in the mortgage sector -- could become an entirely

government-dominated one, which is not appropriate in light of the need to have private-sector housing finance instead of putting taxpayers at risk when private capital stands ready to engage in appropriate, prudential market activity.

I. Current Structure of Private Mortgage Insurance

Before discussing the role of MI in ensuring ample, stable liquidity for banking organizations, MICA would first like to provide the Basel Committee with an update on the regulatory structure, services and recent activities in the private mortgage-insurance industry. We believe this will support the comments presented below regarding the value of MI as a source of net cash inflow under stress scenarios and the importance of comparable requirements for any bank or other guarantees recognized in the liquidity-risk standards.

As noted, private mortgage insurance is a prominent feature not only in the United States mortgage market, but also in other nations, especially those focused on ensuring that low-down payment mortgages – especially important to low- and moderate-income individuals and/or first-time home buyers – are an important part of their national housing-finance system. The World Bank, International Finance Corporation and other multinational development banks have likewise shown consistent interest in the use of MI in emerging housing finance systems. National regulatory schemes for MI vary, but in all cases a strong regulatory framework is essential for a prudential MI system upon which the banking sector of a nation depends. MICA believes that the U.S. regulatory framework for MI has proven to be valuable in ensuring a sound, capitalized form of credit risk mitigation in the U.S. Our comments below will thus generally focus on U.S. developments. We would note, however, that the Joint Forum of global banking, securities and insurance regulators has recently taken a favorable view of the importance of MI for international mortgage markets, noting 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 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).[2]

As noted, creditworthiness and reserve requirements are vital to ensuring that MI is robust mortgage CRM. These demonstrably exist in the U.S. regulatory structure for private mortgage insurance, as evidenced by the fact that private MIs have paid claims and booked loss reserves for calendar years 2007 through 2009 totaling almost $25 billion. MI firms have absorbed this catastrophic risk and continue to do so. In fact, even as the crisis continues, private capital is coming into the U.S. MI industry, demonstrating not only MI resiliency, but also investor confidence in it.

To be sure, recent events have strained the industry in general and some firms in particular, but a unique feature of U.S. MI capitalization has ensured ongoing claims-paying capacity. This is the "contingency reserve," a form of capital analogous to the counter-cyclical capital structures extensively discussed in the regulatory-capital portions of the consultative paper. In the U.S., mortgage insurers are generally required to hold half of every premium dollar in this reserve for ten years to ensure that firms can withstand even catastrophic-risk scenarios such as the one recently experienced in the U.S. In other countries MI premiums are paid up front so that the equivalent of catastrophic reserves are essentially held in unearned premium reserves.

MIs are distinguished not only by counter-cyclical capital, but also by regulatory policy that prevents specific wrong-way risk. Simply put, U.S. MIs are not permitted by applicable state insurance law and rule to invest in mortgage-related assets. MIs are monoline insurers – they may provide only protection for residential mortgages but, in sharp contrast to monoline bond insurers – which in fact invested in precisely the same complex structured investments they insured – MIs may hold only resources with minimal correlation to the mortgage risk they insure. This buttresses counter-cyclical capital to ensure claims-paying capacity under stress because specific wrong-way risk is averted.

In addition to its capital resources with which to honor claims, MIs can also play a critical role in providing market discipline (that is, Pillar 3) support for prudent mortgage practices. Because MI is generally in a first-loss position, considerable care needs to be taken at loan origination to ensure that mortgages in fact meet all the terms and conditions appropriate for insurance coverage. When properly

---

[2] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation*, Key Issues and Recommendations, page 17 (Jan. 2010), *available at* http://www.bis.org/publ/joint24.pdf?noframes=1.

implemented by both the MI and the lender, this "second underwriting" can help to ensure that insured loans sold into secondary markets or held in bank portfolios meet designated underwriting criteria.

The monoline structure also provides MIs with another prudential benefit: the franchise value of each mortgage-insurance firm relies on its claims-paying capacity and – importantly – its willingness to honor all valid claims. If MIs failed to meet their commitments, they would find themselves frozen out of the mortgage-insurance business and, as monolines, they would thus cease to exist. We understand that some have suggested that MIs are shirking claims-paying responsibilities as rescissions have recently risen, but MICA strongly refutes this suggestion. Rescission – denial of claim – is not only legally appropriate, but also a sound prudential response when fraud or similar gross negligence has occurred. Were MIs to pay claims for fraudulent mortgages, it would create the same heedless risk-taking incentives that property-and-casualty insurers rightly address when they refuse fire-damage claims resulting from arson. If moral hazard is not to become the watchword of mortgage finance, rescission must occur by any party with legal rights to do so related to counterparty failures.

Finally, it should be noted that MI is not a traded, uncapitalized instrument like credit default swaps (CDS) and similar instruments. It thus plays no role in market volatility, as evidenced in recent sovereign-debt arenas that have sparked calls in the European Union for a flat ban on CDS trades by dealers without the capital to honor any credit-risk commitment related to the CDS should it fall to them to do so. The United States, European Union and Financial Stability Board have embarked on a reform agenda designed to ensure that CRM provided through risk-transfer structures like CDS are reliable, capitalized and transparent. Unless and until such reforms are enacted and, then, proven under stress, the Basel Committee should not permit banks to reduce risk-based capital or funding based on nominal support through CDS or other structures.

II. Role of MI in the Net Stable Funding Ratio

Because of the regulatory and capital structure of MI as demonstrated above, MICA urges the Committee to ensure that MI is appropriately recognized as a source of net cash inflow for the net stable funding ratio (NSFR), as discussed in detail beginning in paragraph 78 of the consultative paper. While MI can play a role in stabilizing short-term funding concerns, claims-paying commitments are not normally honored within thirty days (the time horizon of the liquidity coverage ratio or LCR). MI is, therefore, principally a concern within the longer-term NSFR.

MI is not, of course, a funding source. It is, however, a source of cash that pays claims that can help to ensure cash inflows under stress scenarios. MI is not germane under some of the stress scenarios outlined in the consultative paper in paragraph 83 (e.g., a counterparty downgrade), but it is directly applicable to others (e.g., a significant credit risk or material market event). When these occur, MI honors its claims and thus immediately provides a counterparty with cash that bolsters liquidity.

In paragraph 91, Table 3 lists off-balance sheet (OBS) structures that may be considered in calculating the NSFR. The table does not make clear that reliable forms of credit insurance such as MI are equivalent to other irrevocable guarantees and thus does not appropriately credit them towards the OBS portion of the NSFR. For the reasons detailed above, MICA recommends that the table be clarified to ensure appropriate consideration of regulated, capitalized CRM.

III. Bank Guarantees Should be Subject to Comparable Liquidity-risk Standards

Paragraph 133 of the consultative paper states that bank affiliates providing guarantees or similar liquidity services should be treated in a fashion comparable to that of non-affiliated entities. MICA supports this proposal to ensure that banking entities are not permitted to provide funding or guarantee services in ways that permit liquidity-risk arbitrage opportunities. The Committee is all too familiar with the regulatory-capital arbitrage opportunities afforded by gaps in the risk-based capital standards and should not permit these to occur in the liquidity-risk arena.

However, we would note that comparable treatment for non-affiliated entities may be insufficient to address all arbitrage concerns. Absent inter-affiliate transaction restrictions comparable to those imposed under the Federal Reserve Act in the United States,[3] banking organizations could obtain funding at a lower cost or in undue amounts from regulated banking organizations. To prevent this, the Basel Committee should ensure not only that the regulatory treatment under the liquidity-risk standards is consistent, but also that pricing and other terms within the banking organization are on an arm's-length basis and that overall exposures are limited.

[3] 12 U.S.C. § 371c-1 (2009).

IV. All Guarantees That Pose Liquidity Risk Should be Reflected

Further, throughout the guidance, the Basel Committee rightly requires consideration of both contractual and non-contractual guarantees to be taken into account from a liquidity-risk perspective. MICA strongly endorses this approach, which should take into consideration all commitments that could pose either a funding- or credit-risk challenge. This should include not just contingent credit instruments (e.g., letters of credit), but also credit default swaps (CDS) and any other commitments in which banks pledge to offset credit, market or other risks. As noted, MIs in the U. S. are required to hold contingency-capital reserves to ensure that they can meet claims even under catastrophic-risk scenarios. Any provider of counterparty-credit risk protection that cannot meet similar requirements should be reflected by higher liquidity-risk requirements in a bank's contingency funding plan. Without comparable capital (not yet required in the risk-based capital standards included in the consultative paper), banks offering CRM will not have adequate counter-cyclical capital comparable to that required of mortgage insurers and thus could experience severe liquidity shocks as they seek to meet claims under stress scenarios.

V. The Liquidity Standards Should be Modulated to Ensure Smooth Implementation

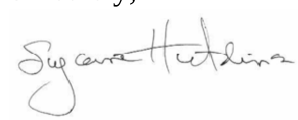
Finally, MICA urges the Basel Committee to take care as the liquidity-risk standards are implemented. As in our comments on the risk-based capital proposals, we would note that the sum total of the liquidity-risk requirements could be so severe as to shock a still fragile banking system. We do not believe that the best way to reflect this risk is to extend the rules out to an uncertain implementation date as this will result in both uncertainty and potential liquidity-risk arbitrage. Thus, we suggest that the Basel Committee outline a set of initial liquidity-risk standards calibrated together with the capital ones to ensure meaningful risk-management requirements achievable under current market conditions. When these are in place, the Committee could then move on to more stringent requirements and to consideration of any other regulatory standards still considered necessary to prevent another financial-market crisis. We would urge particular care with regard to over-rapid action on pending proposals to require risk retention in asset-securitization structures, as doing so would trigger both capital and liquidity risk requirements. Piled upon those already proposed, risk retention could lead to a quick shut-down in markets that will have difficulty reaching

full vigor under current market conditions and the proposed regulatory requirements.

Conclusion

As noted, MICA generally supports the proposed liquidity-risks standards, especially with regard to clear recognition of the contractual and non-contractual risk associated with bank credit-risk commitments. To ensure that the rules do not adversely affect the fragile recovery now underway in many member nations of the Basel Committee, we suggest clear recognition of reliable forms of credit risk mitigation that ensure net cash inflows under stress. This will enhance liquidity under the NSFR and, thus, make it easier for banks to meet this requirement without any resulting undue leniency in the global liquidity-risk standards.

Sincerely,



Suzanne C. Hutchinson