Mortgage
Insurance
Companies
of America

June 20, 2013

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

RE: Consultative Document, Recognizing the Cost of Credit Protection Purchased

Dear Sir or Madam:

The Mortgage Insurance Companies of America ("MICA") is pleased hereby to comment on the consultation released for comment on *Recognizing the Cost of Credit Protection Purchased*[1]. MICA is the trade association representing the interests of providers of private mortgage insurance (MI) in the United States, advocating on behalf of MI firms with over $ 400 billion of insurance-in-force. Because of our members' deep commitment to providing credit risk mitigation for U.S. residential mortgages, MICA believes it is critically important that regulation identify any types of credit-risk protection that may not in fact provide meaningful insulation from loss, especially where credit protection is given privileged treatment under regulatory-capital standards such as the Basel III Accord.[2]

MICA believes that, where credit risk mitigation ("CRM") provides real credit-risk protection, capital incentives should favor its use because robust CRM reduces a bank's risk and diversifies asset-related exposures throughout the financial system. However, where credit protection may put a bank actually at more risk, it should be sanctioned at least to the extent proposed in this consultation. We believe that the assignment of high risk-weighted asset ("RWA") treatment for certain credit-protection arrangements is an appropriate "Pillar 1" approach, but we suggest it should be supplemented with significant Pillar 2 supervisory guidance and Pillar 3 disclosures to ensure an end to structures that, by virtue of their construction and complexity, can obscure real and, perhaps, imminent risk at banking organizations. As most recently noted by the head of the Bank for

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[1] Basel Committee, *Recognizing the cost of credit protection purchased* (Mar. 22, 2013), *available at* http://www.bis.org/publ/bcbs245.pdf.

[2] Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 16, 2010), *available at* http://www.bis.org/publ/bcbs189.pdf.

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International Settlements (BIS), Jaime Caruana, complexity may well lead to wide divergences in RWAs that should be addressed through supervisory standardization and better disclosure.[3]

In this letter, MICA shall:

- describe the manner in which private MI is robust credit protection and request a clarification in the final consultation to make clear that credit protection backed by capital at risk offered through regulated entities subject to premium governance is not covered by high-cost sanctions even if payments at origination (i.e., from borrowers for MI) are not recognized in a bank's earnings; and

- urge rapid action on a final standard to block growing use of structured CRM instruments that may sow the seeds of future systemic crises.

Market trends are clearly disquieting.[4] Further, some proposals to restructure Fannie Mae and Freddie Mac in the U.S. could lead to significant reliance on structured forms of credit-risk transfer, perhaps sparking another round of systemic risk if these risk-transfer arrangements are not robust.[5]

Although the Basel Committee on Banking Supervision (the Basel Committee) tried to constrain high-cost credit protection with an admonitory statement in December 2011[6], market use of them has only grown. As a result, clear, strong and binding standards are urgently required.

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[3] BIS General Manager Jamie Caruana, *Consistent regulatory implementation to keep markets integrated* (Jun. 3, 2013), *available at* http://www.bis.org/speeches/sp130606.pdf.

[4] See for example, Katy Burne, *One of Wall Street's Riskiest Bets Returns,* Wall Street Journal Jun. 4, 2013*, available at* http://online.wsj.com/article/SB10001424127887324423904578525701936124838.html. While the synthetic CDO described above was not completed efforts to structure them continue, as noted by Tracy Alloway, Tom Braithwaite and Dan McCrum, *Bid to Relaunch Synthetic CDO Unravels,* FT Jun. 16, 2013, available at http://www.ft.com/intl/cms/s/0/313889be-d42c-11e2-8639-00144feab7de.html#axzz2WafeO0d3.

[5] Acting Director Edward J. DeMarco, *Housing Finance, Systemic Risk, and Returning Private Capital to the Mortgage Market* (May 9, 2013), *available at* http://www.fhfa.gov/webfiles/25170/ChicagoFedBankStructureSpeechFinal.pdf.

[6] Basel Committee, *Basel Committee newsletter No 16 "High cost credit protection"* (Dec. 2011), *available at* http://www.bis.org/publ/bcbs_nl16.htm.

I. Private Mortgage Insurance Provides Robust Credit Protection and Should Not Be Covered by This Guidance

In the consultation, the operational requirements for CRM are strengthened so that CRM eligible for preferred risk weightings must:

- represent a direct claim on the provider and explicitly reference specific exposures or pools of exposures resulting in clearly-defined and incontrovertible CRM;
- be provided through irrevocable contracts (with certain exceptions);
- be unconditional;
- not be subject to unilateral cancellation by the provider; and
- not be subject to provider rate increases related to credit deterioration.

MICA would be pleased to provide the Basel Committee with a detailed description of this product in the U.S. In brief, it meets the criteria cited above because:

- it is provided either at the loan level for specific mortgages or against defined pools of mortgage loans;
- an MI policy lasts for the life of the loan unless certain statutory current loan-to-value thresholds are achieved. MIs themselves may never unilaterally cancel or change the terms of the policy absent a failure of premium payments ; and
- MI in the U.S. is regulated by state insurance supervisors. Rules and law here stipulate capital and related prudential requirements, as well as govern the amount of premiums MIs may charge. Thus, insurance is both robust and appropriately priced in relation to coverage provided.

We believe it is thus clear on its face that MI structured as required in the U.S. is an eligible form of credit risk mitigation for purposes of favorable risk weightings. However, the proposal suggests that MI might still be covered in its high RWAs by virtue of the manner in which present value for CRM is to be computed. Under the

consultation, banks will need conservatively to calculate the cost of CRM on a present value basis if these costs are not recognized in earnings or common equity Tier 1 capital. This present value would need to be deemed an exposure with a 1,250 percent risk weight.

The proposal provides several ways to calculate present value in technical guidance accompanying the consultation. The second of these is premised on the expectation that the bank pays for CRM, which is of course ordinarily the case. However, as noted above, MI is usually paid by borrowers who wish to obtain a mortgage with a high loan-to-value ratio only available to them from a lender if, as now required in the U.S. for loans sold to the government-sponsored enterprises, MI is in place at origination.

Borrower payment in no way makes the credit-risk protection anything but robust from a lender or investor perspective since, as noted above, MI meets all applicable operational characteristics specified in the proposed revision to the Basel III standards. Indeed, MICA would note that MI in fact generally enhances credit quality and, thus, reduces default risk because MIs have capital at risk and, thus, only insure loans for which they conclude via disciplined underwriting that borrowers have the long-term ability to repay the loan in full. We have conducted extensive research on this issue we would be pleased to share with the Basel Committee.

Based on the foregoing, MICA respectfully requests a clarification in the final consultation to make clear that CRM taken out at origination is not to be covered by the 1,250 percent RWA treatment when the CRM is private MI offered by a regulated, capitalized provider of private mortgage insurance pursuant to applicable national rule and law. Please note that the "materiality threshold" (i.e., the 150 percent risk weighting) does not on its own protect MI because mortgages with high loan-to-value ratios often have far higher risk weightings under the advanced internal-ratings based provisions of Basel II and III.

II. Proposed Standards for High-Cost CRM Should be Rapidly Implemented

With the clarification noted above, MICA strongly endorses the proposed approach to high-cost credit protection. We urge prompt action to finalize the consultation because we see very disturbing signs of resurgent market interest in structured CRM, particularly with regard to tranched securitizations and synthetic structures that parcel risk to third-party investors who may or may not have actual capital at hand to

back their positions (often acquired for trading, not investment purposes) should a loan default or other losses occur.

In the press account noted above regarding high-risk structured credit-risk transfers, it is noted that these instruments are "a sign of how hard Wall Street is trying to satisfy voracious demand for higher returns amid rock-bottom interest rates."[7] The instruments here are synthetic collateralized debt obligations (CDOs), which the article links to their "crisis-era predecessors." In addition to synthetic CDOs – the focus of this article, interest is evident in structured collateralized loan obligations (CLOs), a form of high-cost structured CRM with broad potential to permit non-banks to "profit from regulation."[8]

This occurs because, as was the case in the article that generated the prior conclusion,[9] non-banking institutions structure "tactical opportunity" groups to design products that reduce RWAs without transferring risk in a measurable way to parties able to absorb it, should default occur. This is in sharp contrast to MI, which as noted is in the U.S. irrevocably committed to honoring all valid claims.

While in some ways analogous to pre-crisis CDOs and CLOs, these new structures may well be riskier because recent regulations (including the Basel III capital standards) rightly make it more risky for banks to invest in the structured CDOs they assemble. Able now to circumvent investor demands that they do so (an effort before the crisis at aligning issuer interests with those of investors) on grounds that regulatory sanctions bar such holdings, banks may well be able to arrange even riskier CDOs and/or CLOs than in the past. Another factor heightening risk is the potential for sharply higher risk positions in "shadow" institutions such as the private-equity firm that arranged the risk-transfer CLO for shipping loans cited above. The Financial Stability Board has rightly highlighted the risk of such institutions in its ongoing global "work-streams,"[10] but action to date has not been finalized and thus cannot constrain risk resulting from high-cost credit protection.

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[7] Katy Burne, *One of Wall Street's Riskiest Bets Returns, supra* n. 4.

[8] Michelle Wiese Bockmann, Liam Vaughan and Ben Moshinsky, *Blackstone Profits From Regulation With Citigroup Deal*, Bloomberg News Feb. 28, 2013, *available at:* http://www.bloomberg.com/news/2013-02-28/blackstone-profits-from-regulation-with-citigroup-deal.html.

[9] Ibid.

[10] FSB, *Strengthening the Oversight and Regulation of Shadow Banking* (Apr. 16, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120420c.pdf.

Conclusion

In its recent work, the Basel Committee has rightly acknowledged the risk posed by undue complexity.[11] High-cost credit protection is clearly an effort to exploit current complexity to engineer risk off a bank's balance sheet for regulatory purposes even though it remains a real and present risk from an economic-capital perspective. In time, better supervision of these complex structures may combine with benchmarks or floors along lines noted by the head of the Bank for International Settlements in the speech cited above.[12] However, it may well take years to implement these safeguards and/or to promote the transparency needed for supervisors to anticipate high-risk credit structures before they in fact destabilize banking organizations or the financial system.

As a result, MICA urges the Basel Committee to quickly refine the consultation to clarify the treatment of borrower-paid MI and, then, to quickly issue a final consultation that puts banks and the financial market on notice that risk-arbitrage transaction no longer carry the Basel Committee's stamp of approval.

I shall be pleased to provide any additional information you may need on the views expressed above.

Sincerely,

Susan Ironfield

Susan Ironfield
Acting Executive Director

[11] BIS Chairman Stefan Ingves, *Where to next? Priorities and themes for the Basel Committee* (Mar. 12, 2013), available at http://www.bis.org/review/r130312a.pdf.
[12] Ibid.