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

Dear Sir or Madam:

1. Introduction

This letter is in response to the Basel Committee's discussion paper – "The regulatory framework: balancing risk sensitivity, simplicity and comparability, July 2013" (Discussion paper).

Genworth Financial, Inc. is a leading financial services company dedicated to providing insurance, investment and financial solutions to more than 15 million customers, with a presence in more than 25 countries. Genworth traces its insurance underwriting experience back to 1871. We are headquartered in Richmond, Virginia and have approximately 6,300 employees.

Genworth's Global Mortgage Division (Genworth) is a globally active private provider of mortgage insurance (MI)¹ protecting financial institutions against losses arising from borrower default on high loan-to-value prime residential mortgage loans. It has been in operation for over 30 years, experiencing a range of property cycles across a range of countries, including the United States, Canada, Mexico, Australia, New Zealand, and eight European Union member states: the United Kingdom, Ireland, Spain, Italy, Portugal, Sweden, Finland, and Germany. As of the end of the fiscal year 2012, Genworth's Global Mortgage Division had a Risk-In-Force of USD 230 Billion.

By virtue of this unique position, we at Genworth understand the importance of credit risk mitigation thoroughly and firmly believe that any robust capital adequacy framework should

¹ Mortgage insurance, depending on the jurisdiction is also called lenders mortgage insurance, private mortgage insurance, or mortgage guarantee insurance. The Joint Forum, Mortgage insurance: market structure, underwriting cycle and policy implications, (August 2013) available at <https://www.bis.org/publ/joint33.pdf> at page 1, footnote 1; MI is also distinguishable from financial guarantees. The Joint Forum, "Review of the Differentiated Nature and Scope of Financial Regulation, Key Issues and Recommendations," (Jan. 2010), available at <http://www.bis.org/publ/joint24.pdf?noframes=1> at page 17 for the treatment of MI and compare the treatment of financial guarantees and credit default swaps starting at page 68.

create the right incentives for lenders for measuring and managing credit risk appropriately. We welcome the principle behind the need for simplification, consistency and comparability of the capital adequacy framework. However, we believe the framework can be improved further and believe that some of the concepts discussed in the paper could potentially create the risk of moral hazard. As a global mortgage insurer, we would like to take this opportunity to share our views on some of the proposed alternatives.

2. Risk sensitivity must be maintained, else risk of moral hazard

The objective of any robust capital adequacy framework should be to incentivize prudent risk sensitive measurement and management practices. Whilst simplicity is desirable, it should not come at the expense of compromising with key objectives of the Basel framework. Amongst other objectives, one of the primary aims of the capital adequacy framework, as noted in the discussion paper, is to:

- “take into account the effects of capital requirements on banks’ risk-taking incentives, e.g. when faced with regulatory constraints on their capital (and therefore the size of their balance sheet) to seek higher risk assets as a means of boosting expected returns; and
- promote improved risk measurement and management within banks.”²

Given the continued emphasis on maintaining risk sensitivity, it is important that any change to the existing framework should not disincentivise banks’ from assessing and managing risk appropriately. However, we are concerned that the non-risk based measures mentioned in the discussion paper, such as the use of floors, would lead to exactly that if not carefully calibrated.

This will defeat the primary objective of risk management and create the risk of moral hazard. Such measures could incentivise banks to re-balance portfolios in favour of riskier assets that provide higher returns on the same amount of capital as the less risky ones. Instead, the focus should be to incentivise banks to adopt credit risk mitigation techniques on riskier assets.

We have listed our views in the subsequent sections regarding the risks posed by these measures and how these risks can be mitigated.

² Discussion paper at page 8.

3. Alternate proposals that are non-risk based and how they can be enhanced

A. Leverage ratio

This measure has been introduced to reinforce the risk-based capital requirements with a non-risk based “backstop” that provides a floor to the outcome of risk-based measures providing protection against model risk and reduction of capital requirements via optimistic use of models and parameters.

Whilst the principle behind this approach is welcomed, it poses a practical problem. In theory, the leverage ratio output is meant to serve as a “floor”, to protect against optimistic use of internal models. However, the practical challenge is that if the models remain optimistic, then the capital requirements get dictated by the leverage ratio rather than the lenders’ internal models. In such a situation, all loans get assigned the same capital requirement “floor”, regardless of their risk characteristics. Given that riskier assets often generate greater returns, and under this arrangement would consume the same amount of capital as less risky ones, there is a natural incentive for banks to rebalance their portfolios in favour of the latter.

For example:

For the residential mortgage asset class, consider a hypothetical example of a lender, where the Internal Ratings Based (IRB) models are only moderately conservative. Say for a 60% Loan-to-Value (LTV) ratio loan, the model produces a Risk Weight (RW) of 5% (@ 0.25% Probability of Default (PD) based on the internal models and 10% Loss Given Default (LGD) floor) and for a 95% LTV, it produces a RW of 25% (@0.50% PD and 30% LGD as per IRB models). At a capital ratio of 12%, the capital associated with the loans would be 0.6% and 3% respectively.

If leverage ratio constraint requires the lender to hold at least 3% capital regardless of the riskiness of the assets, then it would require it to hold 3% for both 60% as well as 95% LTV loans. It would be incentivised to change its portfolio mix in favour of the riskier 95% LTV versus 60%.

The one way to prevent this moral hazard is to ensure that the internal models are adequately conservative in the first place, and include adequate risk mitigation such as MI, thus removing the need for any backstop measure. The supervisory authorities in various jurisdictions are already taking actions to ensure conservatism in internal models. Another possible way to ensure capital adequacy would be to revise the capital formula itself, as discussed below.

B. Floors and Caps

Floors and benchmarks carry the same risk as discussed above with respect to leverage ratios – if the standard is not reasonably calibrated to the risk, where the standard is above the economic capital, then the regulation itself creates the incentive towards capital arbitrage and the assumption of a more risky portfolio at a substantially similar level of capital. This arbitrage creates and exacerbates the issue highlighted in footnote 18 of the Discussion paper that the “addition of floors can affect the comparability of outcomes in terms of their risk-sensitivity, an example of trade-off between mitigation of consequences of complexity and comparability of outcomes.” (at p. 18)

In addition to the floors outlined in paragraph 62 of the Discussion paper, recent press reports have included the possibility of adding LTV criteria to the Basel Rules³. Genworth urges great care in this approach and, as detailed below, instead urges the Basel Committee to increase the risk weighting for higher LTV loans, with offsetting partial recognition of risk mitigation techniques such as MI, rather than capping them. Invariably, there are serious political economy questions when LTV limits are put in place, especially as pertains to first-time homebuyers. In addition, the markets work quickly to undermine them, especially if there is no allowance for relief for first time homebuyers, such as MI.⁴ Some observers of LTV caps as macroprudential tools have recognized the utility in coupling with MI or other outlets for first time homebuyers.⁵ The question of the adequacy of down payment is better

³ See, inter alia, “Banks watchdog backs away from strict requirements,” Financial Times, September 29, 2013.

⁴ The LTV limits imposed by the Reserve Bank of New Zealand as of October 1, 2013, are the most recent example. The press discussion of arbitrage began before the limits were even officially announced. “Home-loan brake could fail; Expert: Ways to get around rules,” The Dominion Post (Wellington, New Zealand) July 16, 2013 Tuesday, p. 4. Even with eventual exceptions, including for loans supported by the government MI program and an allowance for 10 percent of the mortgage book to be in higher LTV mortgages, the press continued to discuss arbitrage. “Getting creative to beat the new bank lending rules; Richard Meadows has 10 creative strategies for thumbing your nose at the Reserve Bank’s rules and getting your foot on the property ladder,” The Dominion Post (Wellington, New Zealand) October 1, 2013 Tuesday, at page 6. Three days later, the Governor publicly defended the program in an opinion piece. “Graeme Wheeler: Brakes on lending aim to cut risks” The New Zealand Herald October 3, 2013 Thursday, available as “Why Loan-to-Value Ratios were introduced”, at <http://www.rbnz.govt.nz/news/2013/5478390.html>.

⁵ International Monetary Fund, Canada, 2012 Article IV Consultation, Selected Issues, (February 2013), available at <http://www.imf.org/external/pubs/ft/scr/2013/cr1341.pdf>; see, also, Wong, Eric, Tom Fong, Ka-Fai Li and Henry Choi, (2011) “Loan-to-Value Ratio as a Macro-Prudential Tool – Hong Kong’s Experience and Cross-Country Evidence” Hong Kong Monetary Authority, Working Paper 01/2011, (17 February 2011) available at http://www.hkma.gov.hk/media/eng/publication-and-research/research/working-papers/HKMAWP11_01_full.pdf at 1, stating “Although the tool [LTV caps] could impose higher liquidity constraints on homebuyers, empirical evidence shows that mortgage insurance programs (MIPs) that protect lenders from credit losses on the portion of the loans over maximum LTV thresholds can mitigate this drawback without undermining the effectiveness of the tool. This finding indicates the important role of MIPs in enhancing the net benefits of LTV policy.” and Joint Forum (2010) at 17, stating: “Mortgage insurance provides

left to national regulators and supervisors as indicated in the principles outlined by the Financial Stability Board's "Principles for Sound Residential Mortgage Underwriting Practices"⁶. Finally, LTV caps as a floor do not seem to meet the criteria outline in paragraph 63 of the Discussion paper.

Genworth believes that the Basel Committee should instead convert the correlation factor of the residential mortgage formula from a constant into a variable based on LTV ratio, thus increasing the capital requirements for higher LTV mortgages that do not have an offsetting mitigant like MI. LTV caps or increases to the LTV floors for residential mortgage risk do not as accurately capture the risk. Converting the correlation factor to a variable better meets the criteria in paragraph 62, and especially the requirement in criteria (ii) "that [new measures] provide additional comfort that banks' risks are adequately capitalized." For full analysis of this approach, please refer to Genworth's public submission to the original Basel III consultation⁷.

The approach advocated by Genworth, to convert the correlation factor from a constant to a variable, has been adopted recently by the Reserve Bank of New Zealand.⁸ The Reserve Bank expressed its view in light of:

- "The way that the Basel equation correlation factor was determined does not take account of New Zealand conditions and may not be suitably calibrated to downturn conditions (especially given the experience of the global financial crisis).
- The Basel equation correlation factor is fixed across all housing loans notwithstanding the fact that some categories of loans are more vulnerable to systemic risk than others.

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." and Yue E, (2001) "Marrying the micro- and macro-prudential dimensions of financial stability – the Hong Kong experience", BIS Papers, no 1, pages 230-240, available at <http://www.bis.org/publ/bppdf/bispap01.pdf> at page 231.

⁶ Financial Stability Board, "FSB Principles for Sound Residential Mortgage Underwriting Practices", (April 2012) available at http://www.financialstabilityboard.org/publications/r_120418.pdf at page 4.

⁷ Genworth Financial, Inc., "Submission (16th April 2010) to the Consultative Paper on Strengthening the Resilience of the Banking Sector" available at: <http://www.bis.org/publ/bcbs165/genworthfinanci.pdf>

⁸ Reserve Bank of New Zealand, "Capital Adequacy Framework (Internal Models Based Approach)" (BS2B) (September 2013) available at http://www.rbnz.govt.nz/regulation_and_supervision/banks/banking_supervision_handbook/3272068.pdf and the cost benefit analysis supporting the addition of the correlation variable, Reserve Bank of New Zealand, "Regulatory impact assessment of the review of bank capital adequacy requirements for housing loans (stage one)." (May 2013), available at http://www.rbnz.govt.nz/regulation_and_supervision/banks/policy/5253294.pdf.

- Our assessment of the relevant literature, which implies: (a) that the correlation factor may not be sufficiently attuned to times of market stress; (b) there is some empirical support for a correlation factor of around 20-25 percent for loans with an LVR of 80 percent or more; and (c) application of the same correlation factor globally is unlikely to appropriately differentiate the relative risk profiles in different regions.
- The findings of our own modelling that correlation should on average be significantly above 15 percent and should differ with LVR.
- Bank data received on loss rates by LVR category that suggests higher LVR loans may be subject to more systemic risk.”⁹

Genworth’s experience with mortgage default risk across time periods, economic cycles, and national borders is consistent with the Reserve Bank of New Zealand’s finding, as expressed in our previously cited submission to the Basel Committee.

For example, as noted in the Discussion paper, LGDs for residential mortgages have a 10% floor. Even this floor has demerits, for it is not really a floor, particularly as implemented in the European Union’s Credit Risk Regulation (CRR) Article 164, in that it has an exception for mortgages that are guaranteed by sovereign guarantees and state owned MIs, but not for private MI. In addition to the inherent unlevelled “playing field,” such a standard creates capital arbitrage towards sovereign guarantees. This arbitrage further reduces the comparability between jurisdictions as outlined in paragraph 63 of the Discussion paper where national policy leaders have elected to have a sovereign MI programs.

Genworth would recommend reducing this arbitrage opportunity by allowing both public and private programs to be modeled. The floor was originally imposed to mitigate the risk of under capitalisation caused by the internal models potentially underestimating losses. Whilst this argument is valid for uninsured loans, mortgages covered by MI have reduced losses as the insurance is designed to, depending on the jurisdiction’s coverage amount, to bridge or partially bridge the shortfall between recoveries from the underlying property and the outstanding loan amount. Hence, there is a very remote risk of undercapitalisation, rendering the 10% floor redundant for loans with MI.

Genworth is also mindful of the concern expressed in paragraph 64 that any new rules not “creating an unduly mechanistic reliance on external credit ratings.” And Genworth believes that any new Basel rule should create a level playing field not only between sovereign and corporate risk, but also among types of financial services corporates where they are similarly regulated and capitalized. Introducing risk sensitivity to floors/caps in this manner will satisfy all requirements on simplicity, comparability and risk sensitivity, while ensuring capital

⁹ Ibid at page 5.

adequacy of the financial system and maintaining the right incentives for prudent risk management.

4. Incentivising risk mitigation provides structural stability to the financial system, complements banking capital with mortgage insurer's, and also imposes market discipline

Providers of credit risk mitigation not only strengthen lenders' balance sheets by enhancing their loss absorption capability but also reinforce market discipline with a separate set of credit risk criteria, contribute additional capital capacity to the financial system, and serve to diversify risk. These points have been elaborated below, again taking the example of residential mortgages and mortgage insurers.

A. Insurers provide diversification of risk and bring additional capital to the financial system

Insurers diversify risk across lenders, segments and jurisdictions. Even a large internationally diversified bank can benefit from further diversification provided by a large global insurer. This benefit could become more relevant under any new regulatory regime that demands banks to "ring-fence" retail assets within geographies, thereby restricting mutualisation as an unintended consequence.

In addition to providing structural stability, well-capitalized and well-regulated mortgage insurers ensure that credit flow is maintained in the system for good-quality borrowers throughout the economic cycle.¹⁰

B. Insurers re-enforce market discipline

Finally, insurers act as "second-pair of eyes" and re-inforce strict underwriting discipline due to "skin in the game." Mortgage Insurers are primarily in a "first loss" position. When there is a second set of credit risk criteria for the MI, it enhances portfolio quality. Insurers also proactively manage loss mitigation process, leading to benefits for all parties concerned – borrowers get to stay in their homes and lenders are protected from losses.¹¹

C. Insurers complement banks' balance sheets to bring stability to the overall financial system

Owing to a different business model to banks, insurers bring stability to the overall financial system. Insurers' balance sheets are less volatile, and therefore more stable than banks'.

¹⁰ Reserve Bank of Australia, "Box C: Lenders Mortgage Insurance," in, Financial Stability Review, (September 2013), available at <http://www.rba.gov.au/publications/fsr/2013/sep/pdf/0913.pdf> at page 40.

¹¹ See, generally, Joint Forum (2013) opt cited at footnote 1.



Due to the nature of a bank's business model, with the risk of short-term liabilities (*e.g.*, capital markets) funding long-term assets (*e.g.*, mortgage loans), ultimately resulting in asset-liability mismatch. Therefore, banks' assets are more prone to loss in value in a stress situation. On the contrary, mortgage insurers' assets tend to be more liquid, less correlated, and of a high quality due to strict regulatory requirements around investment policies in many jurisdictions.¹² Mortgage Insurers also have to allocate capital and reserves counter-cyclically,¹³ whilst procyclicality has been a major issue with banking reserves, although Basel III seeks to ameliorate that.

5. Conclusion

It is a very welcome idea to simplify the existing capital adequacy framework for banks for greater comparability. However, any enhancement should not adversely impact the risk sensitivity of the framework. In fact, the framework with respect to residential mortgages could be significantly improved by greater risk sensitivity specifically around the correlated risk of high LTV lending. It should therefore also be ensured that any revision should allow recognition of MI within the capital framework. This would alleviate the threat of moral hazard of banks seeking higher risk assets without worrying about risk mitigation.

Regards,

A handwritten signature in black ink, reading "Scott D. Quesenberry". The signature is fluid and cursive, with a long horizontal line extending from the end of the name.

Scott D. Quesenberry
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¹² Ibid at page 3.

¹³ Ibid at page 9.