



March 27, 2015

BY ELECTRONIC SUBMISSION

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Re: **Recognition of Risk-Reducing Effect of Mortgage Insurance and Risk-Increasing Effect of Simultaneous Second Lien Mortgages in Revisions to Risk Weight of Residential Mortgages under the Standardized Approach**

Dear Sirs and Madams:

U.S. Mortgage Insurers ("USMI")¹ welcomes the opportunity to offer our response to the Basel Committee on Banking Supervision (the "BCBS") on the consultative document, *Revisions to the Standardised Approach for credit risk* (Dec. 22, 2014) (the "Proposal"), which would, among other things, revise and replace the risk weight for exposures secured by residential real estate under the standardized approach for calculating credit risk under the Basel capital framework (the "Standardized Approach").² The Proposal would generally assign a risk weight to residential mortgages based on the exposure's loan-to-value ("LTV") ratio, and in the case of exposures to individuals, the debt service coverage ("DSC") ratio.³

¹ USMI is a trade association composed of the following private mortgage insurance companies: Arch Mortgage Insurance Company, Essent Guaranty, Inc., Genworth Financial, Mortgage Guaranty Insurance Corporation, National Mortgage Insurance Corporation, and Radian Guaranty Inc.

² Basel Committee on Banking Supervision, *Revisions to the standardised approach for credit risk* (Dec. 22, 2014), available at <http://www.bis.org/bcbs/publ/d307.htm>.

³ *Id.* at Annex 1 ¶¶ 38-42. To qualify for this risk weight approach, an exposure would need to be secured by a mortgage on residential property, the risk weight could not be materially dependent on the performance of the property securing the mortgage or the performance of the borrower, the property would need to be fully completed (subject to the discretion of national regulators to deviate from this requirement in the case of one to four family residential housing units), the claim on the property would need to be legally enforceable in all relevant jurisdictions, and the property would need to be valued according to certain delineated criteria. *Id.* at Annex 1 ¶¶ 36-37.

The Proposal does not appear to recognize the risk-reducing effect of private mortgage insurance in the calculation of residential mortgage risk weights. Nor does the Proposal appear to recognize the risk-**increasing** effect of simultaneous second lien mortgages on primary residential mortgage exposures.

We understand that the Proposal is intended to achieve a more accurate risk calibration of banks' credit exposures to residential mortgages than the existing Standardized Approach. In furtherance of this goal, Part I of this letter describes why the revised Standardized Approach should recognize mortgage insurance as reducing the risk weight assigned to a residential mortgage covered by such insurance. As discussed in more detail below, such treatment would be consistent with the capital requirements established in several BCBS member countries, including the United States, where the risk weight associated with a residential mortgage ultimately may be decreased due to mortgage insurance. To gain comfort that the mortgage insurance provided by a private mortgage insurer warrants this treatment under the Standardized Approach, the BCBS could require the insurer to satisfy eligibility standards, including financial health and risk management standards. At a minimum, the Basel Standardized Approach should provide discretion to BCBS member countries to recognize mortgage insurance as they deem appropriate given the regulatory and market characteristics of mortgage insurance in each jurisdiction.

Part II of the letter sets forth why the revised Standardized Approach should use the **combined** loan-to-value ratio, or "CLTV" ratio, incorporating the value of all senior, equivalent, and junior liens on the same residence originated at the same time as the bank's mortgage, rather than the significantly less accurate LTV measure, to assign risk weights to residential mortgages. Using the CLTV ratio would accord with the widespread concern that simultaneous second lien mortgages substantially increase residential mortgage losses, as evidenced during the recent financial crisis.

I. The Standardized Approach Should Recognize the Risk-Reducing Effect of Mortgage Insurance.

A. Mortgage insurance plainly reduces the risk of a residential mortgage.

As the Proposal recognizes, when a borrower makes a larger down payment on a residential mortgage, it reduces the lender's risk by reducing the lender's loss if a default should occur—the "loss given default" or "LGD"—as well as the probability of a default occurring in the first instance—the "probability of default" or "PD." Similarly, the use of prudently underwritten mortgage insurance decreases both the loss given default and the probability of default.

With respect to the former, the fundamental purpose of mortgage insurance is to reduce a lender's loss when, in the wake of a borrower's default, the outstanding amount of the mortgage loan exceeds the value of the secured residence. The borrower pays the insurance premium, but the lender is the policy beneficiary, and the amount of loss coverage is usually

capped as a proportion of lost loan principal. Mortgage insurance thus enables loan originators and loan purchasers to reduce the risk of loss on low down payment residential mortgages by transferring a portion of this risk to third-party insurers that specialize in underwriting and managing this risk. After the borrower's equity, mortgage insurance takes a first loss position on a portion of the value of a loan instead of the lender bearing the loss on that portion.

Mortgage insurance also reduces risk by affording a lender the benefit of additional risk underwriting standards imposed by the mortgage insurer, thereby decreasing the probability of a default of an insured mortgage when compared to a similar uninsured mortgage. The best way for a mortgage insurer to avoid paying a claim is to insure loans that are prudently underwritten. The industry has historical data and deep expertise in data analytics that it uses to understand and assess the probability of default based on loan characteristics, macroeconomic assumptions, and a borrower's credit profile. Mortgage insurers leverage this knowledge to underwrite insurance on mortgage loans they believe are prudent and sustainable. Mortgage insurance thus provides an additional layer of due diligence on the credit risk of borrowers, supplementing the primary due diligence that lenders conduct.

Importantly, in some jurisdictions such as the U.S., mortgage insurance does not insure against 100 percent of the value of a defaulted loan, but rather, typically covers approximately 25 to 35 percent of unpaid loan balances, plus certain additional expenses. In this context, the lender still retains substantial "skin in the game" that incentivizes the lender to carefully underwrite mortgage loans independent of the mortgage insurance.

Empirical evidence demonstrates that mortgage insurance has reduced mortgage lenders' loss given default and probability of default in the U.S. The Urban Institute, a nonprofit think tank, recently released a study examining loan level losses in a pool of 17 million U.S. residential mortgage loans originated from 1999 to 2013, with data provided by Freddie Mac.⁴ This data shows that private mortgage insurance significantly decreased loss severities. As indicated in the chart that follows, loss severities for loans with LTV ratios over 80 (on which mortgage insurance was written) were much lower than for loans with LTV ratios between 60 and 80. In fact, loss severities for the over-80-LTV ratio loans on which mortgage insurance was written were even lower than loss severities for the 60-or-under-LTV ratio loans in almost all time periods covered by the study.

⁴ Laurie Goodman & Jun Zhu, *Loss Severity on Residential Mortgages: Evidence from Freddie Mac's Newest Data* (Feb. 15, 2015), available at <http://www.urban.org/publications/2000092.html>.

Severity at Liquidation by Origination Year, FICO, and LTV (percent)

Year	FICO	≤ 60	60–80	> 80	Total
1999–2004	≤ 700	20.4	31.0	14.9	22.3
	700–750	17.1	29.3	17.8	24.3
	> 750	19.0	29.8	20.8	26.3
	Total	19.3	30.4	15.9	23.2
2005	≤ 700	28.8	40.6	25.2	35.8
	700–750	26.6	39.4	26.8	36.2
	> 750	26.2	39.0	27.9	36.2
	Total	27.7	39.9	26.0	36.0
2006	≤ 700	35.2	45.3	27.0	39.7
	700–750	32.3	43.6	30.1	40.7
	> 750	30.6	42.2	29.1	39.6
	Total	33.5	44.1	28.0	40.0
2007	≤ 700	38.8	46.1	28.6	38.7
	700–750	33.6	43.4	29.3	38.9
	> 750	31.7	41.2	27.8	37.3
	Total	35.9	44.2	28.7	38.5
2008	≤ 700	31.9	43.6	27.5	36.5
	700–750	27.2	40.1	25.3	34.1
	> 750	23.1	37.5	23.3	31.9
	Total	28.6	40.9	25.8	34.6
2009–10	≤ 700	21.9	34.4	16.1	30.2
	700–750	20.5	30.7	13.6	26.3
	> 750	18.5	28.4	13.8	24.5
	Total	20.5	30.7	14.1	26.5
2011–13	≤ 700	0.0	23.7	6.5	17.0
	700–750	10.4	26.1	8.1	15.5
	> 750	0.0	22.1	9.2	15.6
	Total	8.2	23.8	8.3	15.9%
Total		29.2	39.9	23.1	33.9

The Joint Forum has likewise recognized that mortgage insurance can reduce the risks high LTV ratio loans pose to lenders:

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 (eg greater than 80 percent LTV).⁵

B. Mortgage insurers are subject to considerable prudential regulation and oversight designed to ensure that they can pay claims when due.

Mortgage insurers in many jurisdictions are subject to prudential regulatory regimes that are similar to the regimes that apply to other types of insurers and have proven over time to ensure payments of claims and protect policyholders. For example, in the United States,

⁵ Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation*, at 17 (Jan. 2010) available at <http://www.bis.org/publ/joint24.htm>.

private mortgage insurers are subject to a state-by-state regulatory regime, and many states have enacted legislation that limits the ability of insurers to take on risk through restrictions such as contingency reserve requirements; capital requirements; investment restrictions; risk concentration restrictions; and restrictions on engaging in activities other than mortgage-related insurance. Recently, the National Association of Insurance Commissioners has convened a Mortgage Guaranty Insurance Working Group to modernize the Mortgage Guaranty Insurers Model Act adopted in many states. Among other things, the Working Group is expected to recommend adoption of risk-based solvency regulations.

Australia, Canada, Hong Kong, India, and Korea also subject private mortgage insurers to prudential regulation and supervision by consolidated financial regulators that enforce capital adequacy requirements specific to mortgage insurers and set mortgage underwriting standards. In Europe and Mexico, private mortgage insurers are regulated by the insurance regulators and subject to the local Solvency II capital regimes to ensure capital adequacy.

In the United States, a significant motivation for lenders to seek primary mortgage insurance arises from the federal charters of Fannie Mae and Freddie Mac (together, the “Enterprises”). By statute, the Enterprises may only purchase a mortgage with an LTV ratio exceeding 80 if the lender provides eligible credit enhancement, including private mortgage insurance.⁶ To ensure that such insurance is prudently underwritten by mortgage insurers that have the capacity to make payments on valid claims, the Federal Housing Finance Agency (“FHFA”), regulator of the Enterprises, published a draft of substantial revisions to the comprehensive private mortgage insurer eligibility requirements (“PMIERS”) in July 2014.⁷ When finalized and implemented, the revised PMIERS will be a unified and transparent set of risk management, operational risk, and regulatory compliance requirements applicable to all mortgage insurers seeking to do business with the Enterprises. Among other standards, the revised PMIERS would require the liquid assets of an approved insurer to be greater than or equal to a minimum required level, which would be calculated as the greater of (i) a risk-based measure designed to forecast claims to be paid over the remaining life of the insurer’s existing policies under a stressed economic scenario, or (ii) \$400 million.

⁶ In Canada and Hong Kong, mortgage insurance is required on high LTV loans made by regulated deposit-taking institutions.

⁷ See Federal Housing Finance Agency, Draft Private Mortgage Insurer Eligibility Requirements (July 10, 2014), *available at* <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-requests-input-on-draft-PMIERS.aspx>.

C. Recognizing the risk-reducing effect of mortgage insurance in the calibration of risk-weights in the Proposal would be consistent with the risk weighting approaches adopted by several Basel Committee member countries.

There are several ways that the Proposal could be revised to recognize the risk-reducing effect of mortgage insurance, including methods already in effect in many countries. In Australia, Canada, Mexico, and the United Kingdom, the risk-reducing effect of mortgage insurance is recognized through a lowering of risk weights for the capital requirements of lenders.⁸ In the United States, a bank may assign a 50 percent risk weight to first lien residential mortgage exposures that meet certain qualifications, including that they are made in accordance with “prudent underwriting standards,” rather than the 100 percent risk weight that generally applies to non-qualifying residential mortgages.⁹ Interagency guidelines provide that any loan with an LTV ratio that equals or exceeds 90 at origination may be prudently underwritten with appropriate credit enhancement in the form of mortgage insurance.¹⁰

The BCBS could also recognize mortgage insurance in the framework of the LTV ratio risk-weight categories set forth in the Proposal by subtracting the value of mortgage insurance from the loan value in calculating the LTV ratio of a residential mortgage. Such an approach would recognize that mortgage insurance has an economic function similar to a down payment in that such insurance reduces both loss given default and the probability of default when compared to similar uninsured mortgages.

We understand that concerns have been expressed about the ability of mortgage insurers to pay out claims in times of financial stress and truly reduce bank’s losses on insured mortgages. In fact, however, mortgage insurance did cover a significant amount of claims during the financial crisis. For example, in the United States, private mortgage insurers covered over \$44 billion in claims to the Enterprises from the time they went into conservatorship. Nevertheless, to the extent these concerns still exist, the BCBS or national regulators could address them by requiring, as a condition for mortgage insurance to receive recognition under the Standardized Approach, it must be written by financially sound mortgage insurers. For instance, mortgage insurers could demonstrate that they are financially sound by meeting minimum standards of financial condition and risk management, such as the standards set forth in the draft PMIERS.

⁸ Basel Committee on Banking Supervision, *Mortgage insurance: market structure, underwriting cycle and policy implications - final document*, at 2 (Aug. 2013), available at <http://www.bis.org/publ/joint33.htm>.

⁹ See, e.g., 12 United States Code of Federal Regulations (“C.F.R.”) § 217.32(g)(1)(ii).

¹⁰ See, e.g., 12 C.F.R. Part 208, Appendix C, “Supervisory Loan-to-Value Limits,” n.2.

Finally, we acknowledge that mortgage insurance takes different forms and plays different roles in the financial system in various BCBS member countries. National regulators are well positioned to understand— and, as the Financial Stability Board has recognized, to oversee¹¹—the mortgage insurance industry in their respective jurisdictions. Accordingly, if the Basel Standardized Approach does not itself recognize the risk-reducing effect of mortgage insurance—as we believe it should—the standard should, at a minimum, expressly allow national regulators the discretion to recognize mortgage insurance as they deem appropriate in their expert supervisory judgment based on local market conditions and regulatory regimes. This approach would be consistent with numerous other areas of the Proposal that expressly provide national regulators discretion to deviate from various requirements of the Basel Standardized Approach, including the requirement that a residential real estate exposure be secured by a finished residence.¹²

D. Failure to recognize the risk-reducing effect of mortgage insurance would result in more expensive mortgages, tighter mortgage credit, and less low down payment lending supported by mortgage insurance.

Without the credit enhancement of mortgage insurance, many borrowers—especially first-time homebuyers, low-to-moderate income homebuyers, and homebuyers in underserved communities—would not be able to obtain a mortgage that allowed them to afford the purchase of a home, would have to defer their purchase for many years in order to save for a larger down payment, or would face higher costs of home ownership. In the United States, mortgage insurance is the predominant means to satisfy the statutory requirement that the Enterprises obtain credit enhancement for low down payment mortgages and to reduce the risk weight on high LTV mortgages held in bank portfolios.¹³

By ignoring the effect of mortgage insurance, the Proposal would require banks to hold a level of capital against higher LTV exposures supported by mortgage insurance that would not reflect the actual risks of these exposures. As a result, banks would be significantly disincentivized to provide mortgage loans to borrowers who cannot afford a large down payment, even though mortgage insurance can and does reduce the risks inherent in such mortgages. And when banks do provide such mortgages, they would likely charge borrowers

¹¹ Financial Stability Board, *FSB Principles for Sound Residential Mortgage Underwriting Practices*, at 7 (Apr. 18, 2012), available at http://www.financialstabilityboard.org/2012/04/cos_120401/ (“Jurisdictions should ensure that all mortgage insurers be subject to appropriate prudential and regulatory oversight and, where used, represent an effective transfer of risks from lenders to insurers.”).

¹² Proposal at Annex 1 ¶ 37.

¹³ Under the laws governing the Enterprises’ activities, the Enterprises may not purchase a mortgage with an LTV ratio greater than 80 unless the lender provides one of several types of credit enhancements, including mortgage insurance.

more in order to cover the higher cost of capital imposed by the Proposal. The Standardized Approach should not deviate from actual risks, especially when doing so would harm low and moderate income borrowers and first time homebuyers.

II. The Standardized Approach Should Use the Combined Loan-to-Value Ratio for Residential Mortgage Risk Weighting Rather Than the First Lien Loan-to-Value Ratio.

The Proposal would define the numerator of the LTV ratio as the total value of the loan, including other loans secured with liens of equal or higher ranking than the bank's lien securing the loan, but **not** including junior liens.¹⁴ This definition ignores the significant risks inherent in loans with junior second liens originated at the same time on the same residence, also known as "simultaneous seconds."

Simultaneous seconds increase risks to first lien mortgage lenders in at least three ways. First, homebuyers who take out a second mortgage to pay for a down payment on their first mortgage reduce their net equity position in their homes, which correlates with higher LGD and PD. Second, homeowners who make payments on a second mortgage are subject to increased financial burdens, leading to a higher PD. Third, second lien mortgagees, in their role as mortgage servicers, have an incentive to maximize the value of their loans at the expense of first lien mortgages on the same residence, according to a study by the Federal Deposit Insurance Corporation.¹⁵

The International Monetary Fund ("IMF") has found that the CLTV ratio is the "single most important determinant of LGD," as residential mortgages with second liens originated from 1998 to 2009 experienced LGDs a full **41 percent** higher than residential mortgages without second liens.¹⁶ Several U.S. government reports following the financial crisis affirm the IMF's conclusion and establish that second lien mortgages increase both the PD and LGD of first lien mortgages and thereby increase systemic risk.¹⁷

¹⁴ Proposal at Annex 1 ¶ 40.

¹⁵ See Sumit Agarwal et al., Federal Deposit Insurance Corporation, Second Liens and the Holdup Problem in First-lien Mortgage Renegotiation (Sept. 2012), *available at* <https://www.fdic.gov/news/conferences/consumersymposium/2012/Second%20Liens%20and%20the%20Hold%20Up%20Problem.pdf>.

¹⁶ See Yanan Zhang et al., International Monetary Fund, Local Housing Market Cycle and Loss Given Default: Evidence from Sub-Prime Residential Mortgages (July 1, 2010), *available at* <https://www.imf.org/external/pubs/cat/longres.cfm?sk=24057.0>.

¹⁷ See, e.g., Donghoon Lee et al., Federal Reserve Bank of New York, *A New Look at Second Liens* (Aug. 2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr569.html (using data from credit reports and deed reports to demonstrate that second lien mortgages, particularly simultaneous (continued...))

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To ensure that risk weights under the Standardized Approach accurately capture the economic reality of residential mortgage lending, USMI urges the BCBS to require calculation of the LTV on a combined basis that not only represents the value of a bank's mortgage loan, but also the value of all loans secured by junior, equivalent and senior liens originated at the same time on the same residence. Using the CLTV ratio, with an appropriate reduction for mortgage insurance, will enhance the calibration of risk-based capital to better reflect actual risk.

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Thank you for considering the issues raised in this letter. Questions or requests for further information should be directed to the chair of USMI, Rohit Gupta, at info@usmi.org.

Sincerely,

U.S. Mortgage Insurers

closed-end second mortgages, were associated with loans to low-quality borrowers originated during the housing bubble that experienced higher rates of default, and continue to “pose a potential risk to the banking system” even after the financial crisis).