Mortgage Insurance Companies of America

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Executive Vice President

July 31, 2003

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

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the third consultative paper (CP3) proposed by the Committee as a new framework for international bank supervision. [1] We strongly support a meaningful three-pillar approach, where information regarding risk management and capital allocation is rigorously analyzed by and disclosed to external parties. We believe that the new world of Basel II will be well-served by a supervisory framework that emphasizes specialist knowledge and transparency. In our particular area of expertise, residential mortgage credit risk, establishing appropriate regulatory capital standards for residential mortgages will encourage increased lending without undue risk, promoting this important financial service that promotes home ownership and overall economic development.

Since the Basel II process is at an advanced stage, we will confine our remarks to four brief items:

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[1] "Mortgage Insurance" protects lenders and investors against credit losses suffered as a result of borrower default. Private mortgage insurance is offered by highly rated (AA or better), monoline specialists that operate under prudentially restricted conditions related to marketing, reserving and investment in order to offer credit enhancement that pays claims even under extreme market conditions. Popular in the US, Canada, Australia and the United Kingdom, private mortgage insurance has been introduced in recent years in Spain, Portugal, Italy, Sweden, Ireland, the Netherlands, Hong Kong, Taiwan and Israel. Like the public mortgage guarantee facilities in the Netherlands, Sweden, Finland, France, Belgium, Canada, the United States, Latvia and Lithuania, private mortgage insurance offers protection against credit risk in a form that satisfies the "direct, explicit, irrevocable and unconditional" requirements established by the Basel Committee for guarantees.

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1. First, based upon MICA analysis and studies conducted by U. S. Federal Reserve Board staff, the 15% asset correlation factor under the internal ratings based (IRB) approach generates capital requirements that do not reflect the additional risk associated with residential mortgages having high initial loan-to-value (LTV) ratios. This underestimation is compounded when the mortgage portfolio is not adequately diversified geographically, and reliable third-party credit risk mitigation is not used to absorb unexpected loss. We have conducted research with staff of the U.S. Federal Reserve Board (FRB) on the question of the appropriate regulatory risk weights for residential mortgages. FRB staff currently is preparing a paper summarizing that and other research dealing with this question. As demonstrated by Figure 1 attached, which is part of that paper and presented here with permission of the FRB staff, our work with FRB staff indicates that even geographically diversified portfolios of high LTV residential mortgage loans to borrowers with low credit risk indicia generates an implied asset correlation factor well above 15%. More importantly, we find that materially higher implied asset correlation factors of 25% or higher are warranted for portfolios of geographically concentrated mortgages from borrowers having higher credit risk indicia.

    - **We believe that the Committee members should consider the results of the forthcoming FRB paper on residential mortgage risk for high LTV mortgages when implementing the Basle II accord. We also believe that, since that paper and other research suggests higher correlation factors are warranted, especially for high LTV mortgages,**

Committee members consider at a minimum restricting the use of the 15% asset correlation factor to high credit quality, first charge residential mortgages with low initial LTV ratios, and allowing the 15% asset correlation factor to be applied to non-qualifying mortgages only when appropriate credit risk mitigation is obtained.

2. Second, within the Revised Standardized Approach, the Committee should apply a similar approach to the proposed 35% concessionary risk weighting for residential mortgages – especially since entities applying the RSA are likely to be smaller, regionally concentrated institutions with (by definition) less sophisticated risk and capital management systems. The underlying intent suggests an appropriate balance between recognition of lower-risk mortgages (low LTV, first charge, high credit quality where systematic loan-level information is available) and higher-risk ones (higher LTV or second charge/subordinate liens or poorer credit quality borrowers). Given the current phrasing, MICA is concerned that the Committee will unintentionally encourage broad application of the 35% risk-weighting category and discourage thoughtful management of credit risk. All residential mortgages are not alike, and the Committee should forcefully underscore this point by explicit reference to qualifying characteristics for the 35% risk weight – at a minimum including low LTV limits, senior priority in terms of recoveries, and non-impaired borrower credit histories.

   - **Although the Committee remains wary of imposing hard LTV standards given the variety of local market customs, traditions and conditions,**

MICA suggests use of an 80% LTV limit as a useful step toward developing a global frontier for residential mortgage credit risk.

3. Third, just as the Basel Committee has shown some sensitivity toward important local differences such as mortgage bonds in Continental Europe, MICA urges similar attention to the subject of credit risk mitigation for residential mortgages. The current Consultative Paper by necessity operates at a high level of abstraction regarding collateral and guarantees as forms of credit risk mitigation. Left unaddressed are the mechanisms used in various national mortgage markets to mitigate credit risk. In the U. S., the largest mortgage market in the world, the principal form of credit risk mitigation is mortgage insurance, a fact recognized by the specific reference to mortgage insurance (pp.69-70) in the Advance Notice of Proposed Rulemaking by U. S. financial regulators on Basel II released on July 11, 2003(http://www.occ.treas.gov/FTP/Release/2003-53a.pdf). Nor is the US the only jurisdiction that uses a form of mortgage insurance or guarantee as a means of mitigating residential credit risk (in large part driven by LTV considerations). Among Basel Committee members alone, Canada, the Netherlands, and Sweden have a mixture of public and private mortgage guarantee facilities, and the UK, Italy, Spain, France and Japan rely significantly on private providers. Our point here is simply made: while other means of credit risk mitigation are available on a theoretical basis, mortgage insurance/ guarantee providers (public and private) offer this capacity now. Given the importance of residential mortgages as

an on-balance sheet asset category, the importance of not interfering with smoothly functioning housing finance systems, and the importance of not privileging "public" over "private" credit risk mitigation approaches, MICA believes that the Committee should recognize the risk-reducing benefits of mortgage insurance/guarantees explicitly and not penalize private providers beyond what is implicit within the structure of Basel II (*i.e.*, the difference between sovereigns and corporates even when similarly rated). Consistent with this, we offer two suggestions.

- **For the Advanced IRB approach, MICA recommends that mortgage insurance/guarantees can be used by lenders to lower their estimates of LGD and reduce LGD below the 10% floor. For the RSA, MICA also recommends that MI be used to reduce to 35% the higher risk-weight imposed on higher LTV loans similar to the approach taken currently by US and Australian regulators[2].** In this fashion, financial regulators would be encouraged to look for risk mitigation alternatives outside the banking system without generating the anxieties consistent with less transparent alternatives such as credit derivatives. Controlled risk transfer to monoline, highly rated, experienced specialists is a means to establish appropriate incentives that link together risk and capital.

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[2] The reasoning is simple, and eliminates much of the complexity associated with the proportional "substitution approach" used for guarantees under the RSA. When offered by an appropriately rated (AA- or better), monoline entity to an appropriate level of exposure, the MI-enhanced mortgage loan performs similarly to an uninsured, lower LTV loan. The proportionate approach does not sufficiently recognize the risk-reducing benefits of "first loss" mortgage insurance.

4. Additionally, we note that a separate approach for modeling new mortgage products is not included in the advanced IRB approach. This may result in new products using the risk characteristics associated with earlier products. To the extent that high risk lending continues to expand and the advanced IRB fails to adjust for the inherent higher risk associated with some new products, insufficient capital will be allocated to risky mortgage products.

    - **MICA believes the appropriate PD and LGD applied to new products should reflect not only the historic performance of the bank's prior portfolio, but also an appropriate multiple to both factors**. This multiple, established by the regulator, should reflect the uncertainty regarding the risk performance associated with the new product and be calibrated based upon the initial LTV and other relevant risk factors of the new product. The multiple should be reduced or eliminated only as the historic performance of the new product over a period including one complete economic downturn becomes evident.

While the Committee has done a commendable job dealing with the complexity of conceptualizing Basel II's new risk and capital management framework, MICA continues to support the Committee's efforts to utilize best available data over the longest available time period and to demand transparency at the cost of regulatory flexibility. Our experience with the sometimes unpredictable behavior of long-term mortgages suggests that data need to reflect cyclical behavior, and our recent work with the Federal Reserve demonstrate the importance of the data set used. Regarding

data and time period, the best antidote to concerns over "pro-cyclicality" is a conservative approach that requires the inclusion of past downturns into the relevant IRB data set.

Also, MICA would emphasize the importance of consistent involvement of expert third parties in the validation of risk management systems, portfolio stress testing, and economic capital models under Pillar 2. Rating agencies are not the only alternative, and we stand ready as a source of specialist expertise. Finally, we support enough disclosure under Pillar 3 regarding credit risk management to satisfy the promise of investor discipline and enough disclosure under Pillar 3 regarding credit risk management to satisfy the promise of investor discipline. At a minimum, we recommend sufficient detail in terms of operational risk management, capital and loan-level information to allow investors to understand the choices being made – for example, there are material risk differences between a mortgage loan with mortgage insurance and a loan carried on a self-insured basis, and investors should be given the opportunity to understand those differences. Beyond that minimum standard, of course, we support a reasonable balance between what is desirable (from a market discipline perspective) and what is practical (from a reporting and process efficiency perspective).

MICA would be pleased to discuss the points raised in this brief letter at your convenience.

Cordially,

Suzanne C. Hutchinson

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Office of the Comptroller of the Currency
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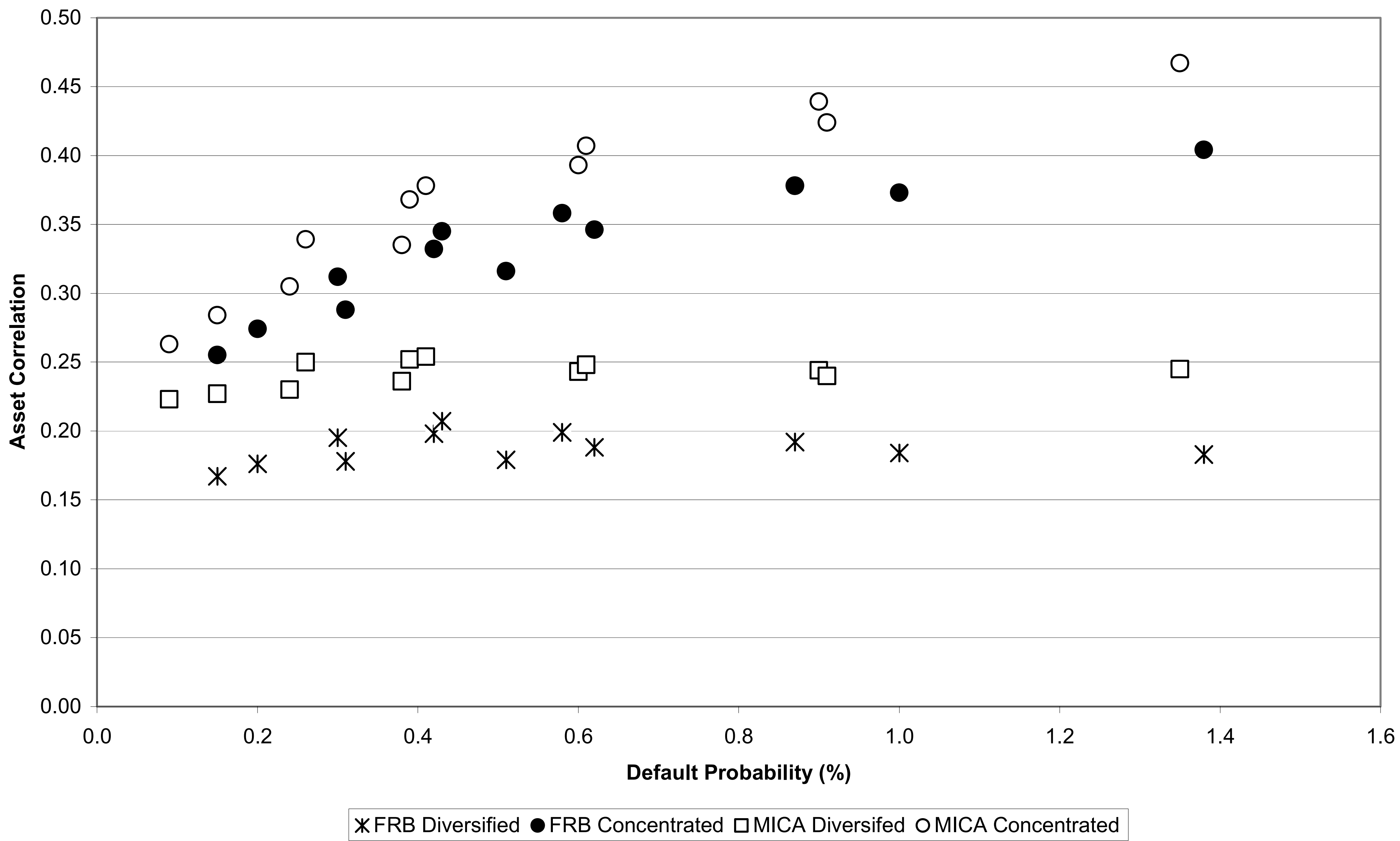
Figure 1: Implied Asset Correlations
BBB+ Insolvency Standard
0.50
0.45
0.40
0.35
0.30
0.25
0.20
0.15
0.10
0.05
0.00
Asset Correlation
0.0
0.2
0.4
0.6
0.8
1.0
1.2
1.4
1.6
Default Probability (%)
FRB Diversified
FRB Concentrated
MICA Diversifed
MICA Concentrated