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Basel Committee on Banking Supervision – Joint Forum
Mortgage insurance: market structure, underwriting cycle and policy implications

Arch Mortgage Insurance Limited ("Arch") response to consultative document
Arch welcomes the consultative document and the work of the Joint Forum.
We provide feedback in respect of the draft recommendations for policymakers and supervisors for recommendations 4 and 5.

4. Supervisors should require mortgage insurers to build long-term capital buffers and reserves during the valleys of the underwriting cycle to cover claims during its peaks;

Arch response
As noted in the consultative document, in the United States supervisors require that mortgage insurers establish a so-called contingency reserve which is a long-term buffer. Supervisory authorities in other countries also currently require buffers for mortgage insurers. The form of the buffer varies by country. We provide examples from the European Economic Area and Australia below.

Supervisors in the European Economic Area require mortgage insurers to establish a so-called equalisation reserve. "Each Member State shall require undertakings established on its territory and underwriting risks included under class 14 in point A of the Annex (hereinafter referred to as "credit insurance") to set up an equalization reserve for the purpose of offsetting any technical deficit or above-average claims ratio arising in that class for a financial year" [1].

Supervisors in Australia require general insurers to hold a so-called concentration risk capital charge. For mortgage insurers, a specific method is required for calculating the concentration risk capital charge[2].

As noted in the consultative document, different approaches may be needed in jurisdictions where the MI product differs. We agree and believe that the approach adopted in a

[1] **Council Directive 87/343/EEC of 22 June 1987, article 15A**
[2] Australian Prudential Regulation Authority, General Insurance Prudential Standard 116

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jurisdiction should be consistent with the overall framework for supervision of reserves and capital for insurers in that jurisdiction.

5. Supervisors should be aware of and mitigate cross-sectoral arbitrage which could arise from differences in the accounting between insurers' technical reserves and banks' loan loss provisions, and from differences in the capital requirements for credit risk between banks and insurers;

Arch response
Capital Requirements

We believe that a ***harmonised approach*** to assessing the capital requirements in respect of mortgage credit risk for banks and mortgage insurers is desirable. We note that a harmonised approach is likely to specify a standardised method to determine capital requirements in respect of mortgage credit risk. This may not be compatible with supervisory regimes which allow for the use of internal models to assess capital requirements, (e.g. IRB approach for banks or internal model approach under Solvency II).

An example of a harmonised standardised method is for supervisors to specify a set of PD factors and LGD factors for mortgage loans which would apply to both banks and mortgage insurers in assessing their capital requirements.[3] The PD factors and LGD factors would be reflective of the experience expected to occur under stressed economic conditions. The PD factors (and possibly LGD factors) might be further specified by risk factors such as loan to value ("LTV"), seasoning, loan type, etc. The greater the number of risk factors used to specify the PD factors, the better the capital requirement for a particular bank or insurer will match the idiosyncratic nature of their mortgage portfolio. However the greater the number of risk factors used to specify the PD factors, the more complex the approach.

Banks which use the IRB approach do so for a number of reasons, one of which is if they have sufficient amounts of credible historic data to derive their own PD and LGD assumptions to reflect the idiosyncratic nature of their risk. The idiosyncratic nature of a high LTV mortgage loan portfolio is important in respect of how the mortgage loan portfolio will perform in terms of loan defaults.

However, we believe high LTV mortgages are more exposed to systemic risk than lower LTV mortgages. A standardised method for capital requirements on high LTV loans applicable to both banks and mortgage insurers will ensure that sufficient capital is held in respect of systemic risk.

We believe that a harmonised approach should adopt a similar method to assess capital across countries, but that the parameters applicable to mortgage credit risk in a particular country should be set by the national supervisor. The parameters are likely to vary by country due to a number of reasons, including the following:

[3] See Concentration Risk Capital Charge method for mortgage insurers; APRA GPS 116

- Whether residential mortgage lending is on a recourse basis or not;
- The extent of social protection benefits available to borrowers who suffer accident, illness or unemployment;
- The characteristics of mortgage loans prevalent in the country, e.g. maximum term, interest only etc. These characteristic may arise due to supervisory requirements or market practice.

In addition, we believe that the reduction in capital requirements for a bank which uses credit risk mitigation[4] in the form of mortgage insurance should be calculated based on the same harmonised approach. This would ensure that cross-sectoral arbitrage does not arise, and also that the benefit of using mortgage insurance for credit risk mitigation is clear and transparent to banks, mortgage insurers and supervisors.

Technical Reserves / Loss Provisions

As noted in the consultative document, depending on the final form of the IFRS and US GAAP requirements for insurance contracts and financial instruments, the future accounting approach applicable to mortgage insurers in establishing technical reserves may be more prudent than the future accounting approach applicable to banks in establishing loan loss provisions. [Bank loss provisions will be based on expected lifetime losses on loans expected to become impaired in the next 12 months, while insured loans would be reserved at a full lifetime loss level].

We comment that the current accounting approach applicable to mortgage insurers in establishing technical reserves is more prudent than the current accounting approach applicable to banks in establishing loan loss provisions:

In respect of defaults which occur after the financial reporting period date (the unexpired period of cover under the insurance contract): mortgage insurers will hold an unearned premium reserve. In addition, mortgage insurers are required to estimate full lifetime losses in respect of the unexpired period of cover. If the unearned premium reserve is not sufficient to cover the estimate of full lifetime losses in respect of the unexpired period of cover, the insurer will be required to establish a Premium Deficiency Reserve, also known as Additional Unexpired Risk Reserve. Note the calculation of the Premium Deficiency Reserve may take into consideration the expenses associated with settling the future losses, investment income and any future premiums contractually due in respect of the unexpired period of cover.

We believe that the supervisors should consider the ***loss paying resources*** of financial entities in respect of their risk exposure. The loss paying resources may be considered to be

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[4] The Basel capital framework recognises that credit risk mitigation techniques can significantly reduce credit risk and can serve as an effective risk management tool. In particular, paragraph 140 of the framework establishes that where guarantees or credit derivatives are direct, explicit, irrevocable and unconditional, and supervisors are satisfied that banks fulfill certain minimum operational conditions relating to risk management processes, banks may take account of such credit protection in calculating capital requirements.

the technical reserves of mortgage insurers / loss provisions of banks plus the capital held in respect of the risk exposure.

Cross-sectoral arbitrage can be mitigated by supervisors ensuring that the loss paying resources of insurers and banks are set at a similar level for entities exposed to similar risk.

Yours sincerely,

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