Mortgage Insurance Companies of America

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October 25, 2010

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Docket Number OCC-2010-0016
RIN 1557-AD35

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AD62

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1391
RIN 7100-AD53

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2010-0027
RIN 1550-AC43

Re: Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the advance notice of proposed rulemaking (ANPR) issued by the federal banking agencies to address the treatment of credit rating agency designations in the risk-based capital guidelines and regulations.[1] Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] ("Dodd-Frank Act") requires removal of references to ratings from all of the agencies' rules, including the risk-

[1] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, 75 Fed. Reg. 52,283 (Aug. 25, 2010).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

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based capital ones issued by all of the federal banking agencies addressed in this ANPR. MICA is the trade association representing the U.S. private mortgage insurance (MI) industry. As such, we have a strong interest in the role of ratings in U.S. residential mortgage finance, and we have long urged considerable caution in this regard.[3] MICA has chosen to restrict its comments in this letter to mortgage-related issues in an effort to provide regulators with the MI industry's unique expertise and data in this critical financial sector.

We have urged this caution and strongly supported reform to the credit rating agency (CRA) industry because, as our letters demonstrate, we anticipated the significant problems that arise from unquestioned reliance on CRA determinations. We also recognized major failings in CRA credit-risk modeling, strongly objecting to the structured-finance arrangements that gave rise to so many AAAs (or equivalent ratings) for high-risk products.

Still, we understand regulatory-agency concern about any precipitous removal of third-party judgments of creditworthiness which, while proven seriously flawed by recent experience, can provide important discipline and transparency to the bank capital rules. We thus provide the agencies with a suggested alternative approach for mortgage-related obligations that builds on Section 941 of the Dodd-Frank Act to provide criteria to differentiate mortgage-backed securities (MBS). MICA does not below address other issues in the ANPR, as these are not germane to the MI industry. In this letter, MICA will make and provide analytical support for the following points:

- MICA understands and respects the complexity of finding alternatives to CRA determinations. However, the agencies should reflect the complexity of credit-risk judgments and avoid over-simple solutions (e.g., broad asset-category criteria). Experience has demonstrated the ability of banking organizations to arbitrage over-simple requirements such as the flat 100 percent risk weighting provided for most obligations under the Basel I rules.[4] MICA believes that the capital rules should look through structured-finance instruments to the nature of the collateral and guarantee, reflecting risk judgments in eligibility requirements without regard to structuring or other, uncapitalized forms of credit risk mitigation.

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[3] See, MICA, comment on *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 74 Fed. Reg. 52,374 (Oct. 9, 2009) *available at* http://www.sec.gov/comments/s7-17-08/s71708-24.pdf; and comment on *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 73 Fed. Reg. 40,088 (July 11, 2008) *available at* http://www.sec.gov/comments/s7-17-08/s71708-8.pdf.

[4] 12 CFR 3, App. A (OCC); 12 CFR 208 and 225, Appendix A (Board); 12 CFR 325, Appendix A (FDIC); 12 CFR 567, subpart B (OTS).

- Judgments about the credit risk of MBS and other mortgage-related obligations should in part be based on the existence of proven, capitalized forms of credit enhancement such as private MI. MICA below provides a detailed update on the condition of the U.S. MI industry to demonstrate that – unique among private sources of capital for U.S. residential mortgage finance – MI is not only honoring its claims, but also has excess capital capacity to promote market recovery. Recognition of robust forms of credit-risk mitigation (CRM) like private mortgage insurance will provide meaningful protection to bank regulators and financial markets, since CRM not only provides an initial layer of risk mitigation, but also "double-default" risk-reduction benefits.

- Congress has established precedent for recognizing MI and other key credit-risk judgments in Section 941 of the Dodd-Frank Act. These criteria apply to all asset-backed securities (ABS) as well as to MBS. MICA urges the agencies to craft a final rule implementing this section of the law to provide criteria for prudent ABS and MBS that may then be reflected in the broader capital rules. The criterion dictated by Congress in Section 941 – demonstrated and historical record of reduced risk of default – governs only "qualified residential mortgages," but it is an appropriate criterion by which to judge all ABS. Congress in section 941 has rightly included use of private MI as a criterion that may determine qualified mortgages.

Finally, we attached to this comment an appendix providing data on the performance of the private MI industry in the recent crisis. It demonstrates the ability of MI not only to reduce default on mortgages, but also to promote "cures" that prevent ultimate default. These data strongly support recognition of MI in future regulatory judgments about mortgage-related credit risk.

I. CRA Judgments Should be Replaced with Care and Prevent Reliance on Subjective, Unproven Credit-Risk Criteria

While MICA strongly endorses stringent CRA reform and the least possible use of ratings in banking regulation, we recognize that changing current rules poses significant problems, especially for smaller banking organizations. We have heard the statements of Chairman Bair, then-Comptroller Dugan and Acting Director of the Office of Thrift Supervision (OTS) John Bowman at the meeting of the board of directors of the Federal Deposit Insurance Corporation (FDIC)

at which the ANPR was approved on August 10, 2010. In a subsequent speech, Daniel Tarullo, Governor of the Federal Reserve Board ("FRB"), noted that:

> [T]he substantial effort expended by staff at the Board and the Federal Reserve Bank of New York to evaluate the creditworthiness of a relatively small number of securitizations in the Term Asset-Backed Securities Loan Facility suggests the enormity of that task [replacing ratings].[5]

These comments reinforce not only the complexity of the task that faces the agencies in the wake of Section 939A, but also the hazard of simple deletion of CRA references without appropriate replacements that meet the goal of credit-risk criteria that are, "transparent, replicable, and well defined."[6] MICA thus opposes options such as use of a simple risk weighting based on factors such as asset class. This would, we believe, put the U.S. back to the 1988 Basel I Accord – if not even the less risk-based capital rules that proceeded it – invalidating all of the work under way since the crisis to craft Basel III. As the testimony presented on September 22 by Treasury Secretary Geithner made clear,[7] U.S. rules must be stringent, properly address credit risk and ensure competitive equity between U.S. banking organizations and foreign entities. These concerns should also drive the agencies as they revise their capital rules, avoiding any new criteria for creditworthiness that could permit regulatory arbitrage or, conversely, place U.S. national banks at a competitive disadvantage. Similarly, MICA urges the agencies not to allow banks to establish capital risk weights for consumer credit exposures, such as residential mortgages, through simple reliance on consumer credit scores. The data presented below highlights the complexities in accurately gauging mortgage credit risk, emphasizing the importance of combined loan-to-value (LTV) ratios at origination, full documentation, and the presence of MI, among other factors.

For the reasons noted above, MICA recommends that the agencies act on an option detailed in the ANPR and assess creditworthiness based on the guarantee or collateral backing mortgages. We shall discuss this option in more detail below with particular regard to the role of private mortgage insurance and the residential MBS market – a critical one for national banks, of course.

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[5] Daniel Tarullo, *speech before the Brookings Panel on Economic Activity* (September 17, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20100917a.htm.

[6] 75 Fed. Reg. 52,283 at 52,286 (Aug. 25, 2010).

[7] Treasury Secretary Timothy Geithner, *testimony before the House Financial Services Committee* (Sept. 22, 2010), *available at* http://financialservices.house.gov/Media/file/hearings/111/Treasury_Testimony092210.pdf.

II. Recognition of Proven Guarantees Will Promote Sound Banking and Market Recovery

MICA members are particularly knowledgeable about the condition of the U.S. residential-mortgage market, and we thus turn to this vital sector in the remainder of our comment letter. We believe that the general approach outlined above to replacing express reliance on CRAs can be applied to residential MBS by reference to proven forms of capitalized credit risk mitigation. Where it exists, creditworthiness is dramatically enhanced as long as the CRM provides a deep layer of first-loss protection and has demonstrated capacity to absorb risk under highly-stress scenarios.

Indeed, reliance on guarantors provides "double-default" protection, rightly recognized in the rules to implement the advanced approaches under the Basel II Accord.[8] Double-default protection means that a bank is at credit risk only upon default of an obligation and, even then, if the CRM provider fails to honor its obligations. Failure to recognize this benefit in any creditworthiness judgments made by regulators in the absence of credit ratings will expose banks to undue and unnecessary risk. It is also a straightforward way to judge credit risk – if a bank has CRM in place on an asset like an MBS and if the CRM meets regulatory specifications, then credit risk is meaningfully reduced in ways that can and should be recognized by the capital rules.

The Joint Forum of global regulators has led the way in work to assess various forms of credit risk transfer (CRT).[9] This work has pioneered reform of credit derivatives, although much work there still is required to achieve the Joint Forum's goal of ensuring capitalized, regulated CRT. However, recognition now of MI and other forms of comparable credit guarantees in regulations to replace CRA reliance will ensure true risk reduction without leading to undue reliance by banks on untested CRT structures or providers.

The performance of private mortgage insurance in the current crisis makes clear how robust this risk-mitigation function has proved and how large a role private forms of credit risk mitigation can play to stabilize key market sectors. MICA members currently have insurance in force of $780 billion, backing residential mortgages with loan-to-value (LTV) ratios above eighty percent. At the end of the second

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[8] See, for example, the applicable treatment in the OCC's regulations, 12 CFR part 3, Appendix C, section 2.

[9] See Joint Forum, *Credit Risk Transfer - Developments from 2005 to 2007* (July 2008), *available at* http://www.bis.org/publ/joint21.pdf; and Joint Forum, *Credit Risk Transfer* (March 18, 2005), *available at* http://www.bis.org/publ/joint13.pdf.

quarter of this year, 7.5 percent of the U.S. residential mortgage sector was protected with private MI.

As the agencies know well, the most critical criterion for credit-risk mitigation is capital, and private MI in the United States is characterized by unique and counter-cyclical capital requirements. Fifty cents of every premium dollar must generally be placed in a contingent reserve for up to ten years, a capital structure designed to ensure the ability of MI firms to bear even catastrophic risk. On page 1 of the attached appendix the historical performance of the MI countercyclical capital model is set forth showing how capital resources are built up during good economic times to pay claims during economic downturns. As noted, the MI capital model is currently working exactly as it was designed to work—paying claims using a decade's worth of premiums.

The current U.S. mortgage market is, of course, exactly such a situation. MICA began to warn regulators of emerging high-risk trends in U.S. mortgage-underwriting practice as early as 2002, and we are grateful for the agencies' role in recognizing these concerns so that meaningful risk-mitigation actions could ensue. This did not occur until the non-traditional mortgage guidance[10] was issued by the federal agencies in late 2006, and implementation and meaningful enforcement was lacking even then. This led to contagion risk, with the problems MICA identified in the subprime sector migrating to the conventional, conforming market, contributing to systemic risk and the conservatorship of Fannie Mae and Freddie Mac.

Despite this, U.S. private mortgage insurers have not only honored their claims, but have also attracted new capital – a tribute to the faith investors have in a sector designed to take risk related to high-LTV mortgages. Since the onset of the crisis, MIs have raised $7.4 billion in new capital, with new entrants to the industry supplementing MI capacity by an additional $575 million in new capital. MIs have also paid $17 billion in claims to Fannie Mae and Freddie Mac, equivalent to over 11 percent of taxpayer investments in the government-sponsored enterprises (GSEs) since the beginning of their conservatorships.

However, MI contribution to credit-risk mitigation is not limited to its unique capital structure. MIs also provide a second set of eyes to review originator practice because MI is capital at risk that ensures incentive alignment with that of borrowers and investors. In

[10] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration, *Interagency Guidance on Nontraditional Mortgage Product Risks* (Sept. 29, 2006), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20060929a1.pdf.

sharp contrast to credit derivatives and financial guarantee insurance (extensively assessed in the Joint Forum papers referenced above), U.S. mortgage insurers are not permitted by state regulation to invest in correlated assets, thus ensuring their capacity to provide not only CRM, but also double-default benefit.

The performance of insured mortgages during the current period of economic and mortgage market stress reflects these important attributes. In the attached appendix we have provided data on the recent mortgage-market crisis and the performance of insured low down payment mortgages versus uninsured comparable mortgages. The details of the study are set forth on page 2 of the appendix. A database of 120 million loans was utilized to determine the performance of qualified mortgages versus non-qualified mortgages during the current period of mortgage market stress

The chart of page 3 of the appendix shows that qualified mortgages—those with full documentation, fixed loan terms and mortgage insurance (if the loan had an LTV above 80%)—performed significantly better than non-qualified loans that were originated during the same years. The study also analyzed 3.8 million residential mortgage loans that were insured and 1.1 million comparable high-LTV loans that were uninsured (these loans were piggyback mortgages).

The chart on page 4 of the appendix shows that the insured loans resulted in 47 percent fewer delinquencies than the uninsured loans. The chart on page 5 shows that insured loans had a 54 percent higher cure rate than uninsured loans. Cured loans are modified or otherwise corrected so that the borrower does not go into default. This in turn ensures lower foreclosures, protecting banks, borrowers and the financial system more generally.

The chart on page 6 of the appendix shows that when looking at the nonperforming rates of the loan by each origination year the ratio of nonperforming piggybacks to nonperforming insured loans averaged 65% higher clearly indicating that insured low down payment loans have a lower risk of default than comparable uninsured loans. Additionally, the chart on page 7 of the appendix shows that qualified insured mortgages performed better than insured mortgages overall and that uninsured high LTV mortgages performed significantly worse than either of the other loan groups. In short, even during the current serious stress period qualified insured loans have performed well.

III. Dodd-Frank Provides Precedent for MI Recognition

Title IX of the Dodd-Frank Act not only requires deletion of CRA references, but also establishes a new framework for the regulation of asset securitization. While seemingly separate, the goals of Section 941 – dealing with ABS – and 939A are consistent: to reduce credit risk in the financial system to protect borrowers, banks and the financial system. Thus, MICA urges the regulators to consider the criteria established in Section 941 that identify "qualified residential mortgages" exempt from mandatory risk retention also as criteria for how much capital banks must hold relative to mortgage credit risk.

Section 941 stipulates the agencies should consider:

> "underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as:
>
> (i) documentation and verification of the financial resources relied upon to qualify the mortgagor;
>
> (ii) standards with respect to—
>
> (I) the residual income of the mortgagor after all monthly obligations;
>
> (II) the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;
>
> (III) the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;
>
> (iii) mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;
>
> (iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and
>
> (v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default."

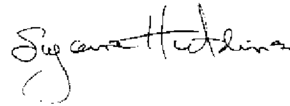
To support Congress' directive that regulators address the historical risk of default, MICA members have developed extensive data. As noted, this is provided in an appendix to this comment letter. It is based on third-party data the agencies may obtain if desired and run on their own to validate the conclusions. The data not only support the foreclosure-prevention conclusions noted above, but also the

historical performance of private MI before and throughout the current crisis.

Conclusion

The Mortgage Insurance Companies of America are pleased to comment on the ANPR to consider alternatives to CRA references in the capital regulations. We respectfully urge the agencies to avoid over-simple alternatives to rating-agency designations and, at the same time, not to defer solely to bank representations of credit risk, as these must be validated by objective criteria such as the presence of proven, capitalized forms of credit risk mitigation like mortgage insurance. We will be pleased to provide additional information on the data presented to support these points and to support the regulators' analytics in any other way of use as the agencies pursue Congress' directive in this area.

Sincerely,



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