March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
ATTN: Docket No. 06-15

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
ATTN: Docket No. R-1238

Mr. Robert E. Feldman, Executive
Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
RIN 3064-AC96
550 17th Street, NW
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2006-49

Countrywide Financial Corporation (CFC) is pleased to comment on the Notice of Proposed Rulemaking ("NPR" or "Basel 1A")) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") regarding the proposed Basel 1A capital regime.

We support the fundamental principles laid out in the NPR: to promote consistency of banking standards, enhance risk management for banks, and increase the sensitivity of regulatory capital to risk exposures. In our comments we have made some recommendations to the Agencies for further enhancing the risk sensitivity of their proposals. While our comments are meant to address the questions posed in the NPR, they are equally applicable for any standardized style approach meant to promote increased risk sensitivity without creating an undue compliance burden.

CFC greatly appreciates the opportunity to share our comments with the Agencies on proposed changes to the regulatory capital rules applicable to banking organizations and looks forward to commenting on future proposals.

Most sincerely,

Patrick Furtaw
Executive Vice President
Countrywide Financial Corporation

Risk-Based Capital Guidelines, Capital Adequacy Guidelines, Capital Maintenance: Domestic Capital Modifications

Question 1: The Agencies welcome comments on all aspects of these proposals, especially suggestions for reducing the burden that may be associated with these proposals. The Agencies believe that a banking organization that chooses to adopt these proposals will generally be able to do so with data it currently uses as part of its credit approval and portfolio management processes. Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.

CFC fully supports the move to a more risk-sensitive regulatory capital framework as proposed in Basel 1A and although we believe the NPR proposals continue to need refinement the Agencies have demonstrated significant progress. By and large, data requirements necessary to address the proposals outlined in Basel 1A are minimal but some additional investment in data collection will be required (see response to question 13). Committing resources in order to comply with a new regulatory framework is acceptable if that framework is appropriately risk sensitive. Accordingly, this investment would be justified if the Agencies were to give serious consideration to reviewing and adopting the recommendations we have outlined in our responses towards making the NPR more risk sensitive.

Question 2: The Agencies seek comment on all aspects of the proposal to allow banks to opt in to and out of the proposed rules. Specifically, the Agencies seek comment on any operational challenges presented by the proposed rules. How far in advance should a banking organization be required to notify its primary Federal supervisor that it intends to implement the proposed rule? If a banking organization wishes to "opt out" of the proposed rule, what criteria should guide the review of a request to opt out? When should a banking organization's election to opt in or opt out be effective? In addition, the Agencies seek comment on the appropriateness of requiring a banking organization to apply the proposed Basel IA capital rules based on a banking organization's asset size, level of complexity, risk profile, or scope of operations.

In order to minimize competitive concerns within the domestic banking industry, the Agencies should allow banks the freedom to choose among alternative risk based capital standards including Basel I, Basel IA and the Standardized and Advanced Approaches from the international Basel II Accord. It is important that risk and capital be appropriately linked for all banks regardless of their size and be linked in such a way as to avoid creating competitive disparities.

Question 3: The Agencies seek comment on whether these or any other new risk weight categories would be appropriate. More specifically, the Agencies are interested in any comments regarding whether any categories of assets might warrant a risk weight higher than 200 percent and what risk weight might be appropriate for such assets. The Agencies also solicit comment on whether a 10 percent risk weight category would be appropriate and what exposures should be included in this risk weight

CFC strongly believes that a 5% to 10% risk weight category is appropriate for retail mortgage risk exposures. For more discussion please see our combined response to questions 7, 9 and 10 (which is set forth immediately after the text of Question 10 below).

For a discussion of risk weights beyond retail mortgages, please see our response to question 4 below.

Question 4: The Agencies solicit comment on all aspects of the proposed use of external ratings including the appropriateness of the risk weights, expanded collateral, and additional eligible guarantors. The Agencies also seek comment on whether to exclude certain externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for all externally rated exposures, collateral, and guarantees. Alternatively, should the Agencies retain the existing risk-based capital treatment for certain types of exposures, for example, qualifying securities firms? The Agencies are also interested in comments on all aspects of the scope of the terms sovereign, non-sovereign, and securitization exposures. Specifically, the Agencies seek comment on the scope of these terms, whether they should be expanded to cover other entities, or whether any entities included in these definitions should be excluded.

In the interest of creating a more risk-sensitive regulatory framework, CFC supports the use of external ratings for risk-weighting all rated exposures. In this regard, our analysis concludes that the proposed Basel 1A risk weights, while sensitive to LTV, are not fully calibrated to the underlying risks. Using NRSRO five-year loss data[1] in conjunction with an economic capital framework, we have analyzed the proposed risk weights and calculated new risk weights that are more closely aligned with NRSRO historic loss data.

As reflected in tables 1 and 2 below, there is evidence of significant differentiation in credit risk between AAA- and AA-rated corporate and securitized obligations. Using an economic capital construct, we assume that capital required over expected losses (proxied by historic loss rates) represents capital being held for unexpected losses. For example, for AAA-rated securitized obligations, a historic loss rate of .02% together with the Basel 1A 20% risk weight

[1] Cf. Moody's Default & Loss Rates of Structured Finance Securities: 1993-2005 (p. 36) and Moody's Default and Recovery Rates of Corporate Bond Issuers: 1920-2005 (p. 15).

and an 8% regulatory capital requirement, imply unexpected losses of 1.58%, which we believe to be exceedingly high given historic loss experience. Accordingly, we suggest that a risk weight of 10% be applied to AAA-rated securitization exposures and non-sovereigns, and that the 20% risk weight be retained for AA-rated exposures.

Table 1 - Securitization Exposures

		Basel 1A Risk Weights			
	Historic Loss Rate	Risk Weight	Regulatory Risk Capital Requirement	%	Implied Unexpected Losses
AAA	0.02%	20%	8%	1.60%	1.58%
AA	0.85%	20%	8%	1.60%	0.75%
A	1.40%	35%	8%	2.80%	1.40%
		Proposed Risk Weights			
	Historic Loss Rate	Risk Weight	Regulatory Risk Capital Requirement	%	Implied Unexpected Losses
AAA	0.02%	10%	8%	0.80%	0.78%
AA	0.85%	20%	8%	1.60%	0.75%
A	1.40%	35%	8%	2.80%	1.40%

Table 2 - Non-Sovereign Exposures

		Basel 1A Risk Weights			
	Historic Loss Rate	Risk Weight	Regulatory Risk Capital Requirement	%	Implied Unexpected Losses
AAA	0.004%	20%	8%	1.6%	1.6%
AA	0.080%	20%	8%	1.6%	1.5%
A	0.227%	35%	8%	2.8%	2.6%
		Proposed Risk Weights			
	Historic Loss Rate	Risk Weight	Regulatory Risk Capital Requirement	%	Implied Unexpected Losses
AAA	0.004%	10%	8%	0.8%	0.796%
AA	0.080%	20%	8%	1.6%	1.520%
A	0.227%	35%	8%	2.8%	2.573%

Separately, we support the Agencies' proposed expansion of eligible collateral and guarantors, and believe, as stated in the proposal, that these steps help to better align regulatory capital with market practices.

Question 5: The Agencies are considering whether to use financial strength ratings to determine risk weights for exposures to GSEs, where this type of rating is available, and are seeking comment how a financial strength rating might be applied. For example, should the financial strength rating be mapped to the non-sovereign risk weights in Tables 1 and 2? Should these ratings apply to all GSE exposures including short- and long-term debt, mortgage-backed securities, collateral, and guarantees? How should exposures to a GSE that lacks a financial strength rating be risk weighted? Are there any requirements in addition to publication and on-going monitoring that should be incorporated into the definition of an acceptable financial strength rating?

CFC supports the use of external financial strength ratings to rate the GSEs. The GSEs are federally chartered agencies that do not carry explicit government support of their obligations, even though an implicit support is thought to exist that the market prices at AAA+. At the same time, the GSEs have financial strength ratings of AA- from external rating agencies which are predicated on their underlying capital base, management strength, etc. In addition, GSEs have preferred stock that does not carry implicit government support and that is rated and priced at AA-.

CFC favors the use of these external financial strength ratings as the most accurate and risk-sensitive measure for capital assessment purposes and we support mapping these ratings to the risk weights in Basel 1A tables 1 and 2.

Question 7: The Agencies seek comment on all aspects of using LTV to determine the risk weights for first lien mortgages.

See our combined response to questions 7, 9 and 10 below.

Question 9: While the Agencies are not proposing to use LTV and borrower creditworthiness to risk weight mortgages, the Agencies may decide to risk weight first lien mortgages based on LTV and borrower creditworthiness in the final rule. Accordingly, the Agencies continue to seek comment on an approach using LTV combined with credit scores for determining risk-based capital. More specifically, the Agencies seek comment on: operational aspects for assessing the use of default odds to determine creditworthiness qualifications to determine acceptable models for calculating the default odds; the negative performance criteria against which the default odds are determined (that is, 60-days past due, 90-days past due, etc.); regional disparity, especially for a banking organization whose borrowers are not geographically diverse; and how often credit scores should be updated. In addition, the Agencies seek comment on determining the proper credit history group for: an individual with multiple credit scores, a loan with multiple borrowers with different probabilities of default, an individual whose credit history was analyzed using inaccurate data, and individuals with insufficient credit history to calculate a probability of default.

See our combined response to questions 7, 9 and 10 below.

Question 10: The Agencies seek comment on whether there are other circumstances under which LTV should be adjusted for risk weight purposes.

We applaud the Agencies for recognizing LTV as a key risk factor. It is an important driver of credit risk and its inclusion increases the risk sensitivity of assigned risk weights. Our analysis finds that the proposed risk weights, though risk sensitive, could be enhanced to better reflect the full underlying risk. For example, two Federal Reserve Board (FRB) working papers[2] calculated economic capital for mortgage loans and found that a capital charge of 0.65% is more than adequate to support the credit risk of a loan with an LTV of 60% or lower. A 0.65% capital charge translates into roughly an 8% risk weight, as compared to the proposed 20% risk weight in Basel 1A NPR.[3] Drawing from the FRB research, we have several suggestions that would more properly align the LTV ranges with the underlying credit risk.

[2] Calem, P.S., and J.R. Follain, 2003, "The Asset-Correlation Parameter in Basel II for Mortgages on Single-family Residences," Working Paper, Board of Governors of the Federal Reserve System, November 6; and Hancock, D., A. Lehnert, W. Passmore, and S.M. Sherlund, 2005, "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization," Working Paper, Board of Governors of the Federal Reserve System, April.

[3] Cf. Calem *et al.* in footnote 2.

- *An LTV range of 60% to 80% captures too wide a credit quality spectrum to assign a truly risk-sensitive risk weight. At a minimum, we suggest that the 60% to 80% LTV range be split into two buckets, one extending from 60% to 70% and another from 70% to 80%, so that more risk-sensitive risk weights may be assigned*
- *A 20% risk weight for loans with an LTV below 60% is unduly punitive. We suggest applying a 5% to10% risk weight to loans with an LTV below 60%, a 20% risk weight to loans in the 60% to 70% LTV range, and a 35% risk weight to loans in the 70% to 80% LTV range*
- *Absent the split, we would urge the Agencies to consider a risk weight lower than 35% for the 60% to 80% range, as it significantly penalizes the higher quality loans within the range (e.g., loans with LTV 60% to 70%)*

We believe that the inclusion of LTV is a move toward a more risk-sensitive framework. However, on its own it does not provide enough information to produce a truly risk-sensitive approach. For example, consider two loans with LTV of 95%, one with a borrower FICO of 550 and the other with a FICO of 800; under the current proposal both loans receive the same risk weight but clearly do not carry the same level of credit risk. As the Agencies have embraced the use of NRSRO ratings to assess capital charges, we encourage the Agencies to permit the use of similar information together with LTV in the assessment of residential mortgage risk: specifically FICO scores. This would harmonize both the conceptual basis of the analysis that the Agencies have adopted in the use of NRSRO ratings and industry practice of employing FICO together with LTV in the assessment of credit risk.
Risk weights based on LTV and creditworthiness would significantly improve the risk-sensitivity of the framework, while only marginally increasing the operational burden. Using the FRB economic capital calculations from the working papers referenced earlier, we have calculated the following implied LTV/FICO risk weights:

	FICO					
LTV	>740	700-740	660-700	620-660	<620	Basel 1A
<60	0%	0%	0%	0%	10%	20%
60-70	0%	0%	8%	20%	39%	35%
70-80	13%	25%	38%	50%	69%	35%
80-85	27%	40%	52%	65%	84%	50%
85-90	42%	55%	67%	80%	99%	75%
90-95	57%	70%	82%	95%	114%	100%
>95	102%	114%	127%	139%	158%	150%

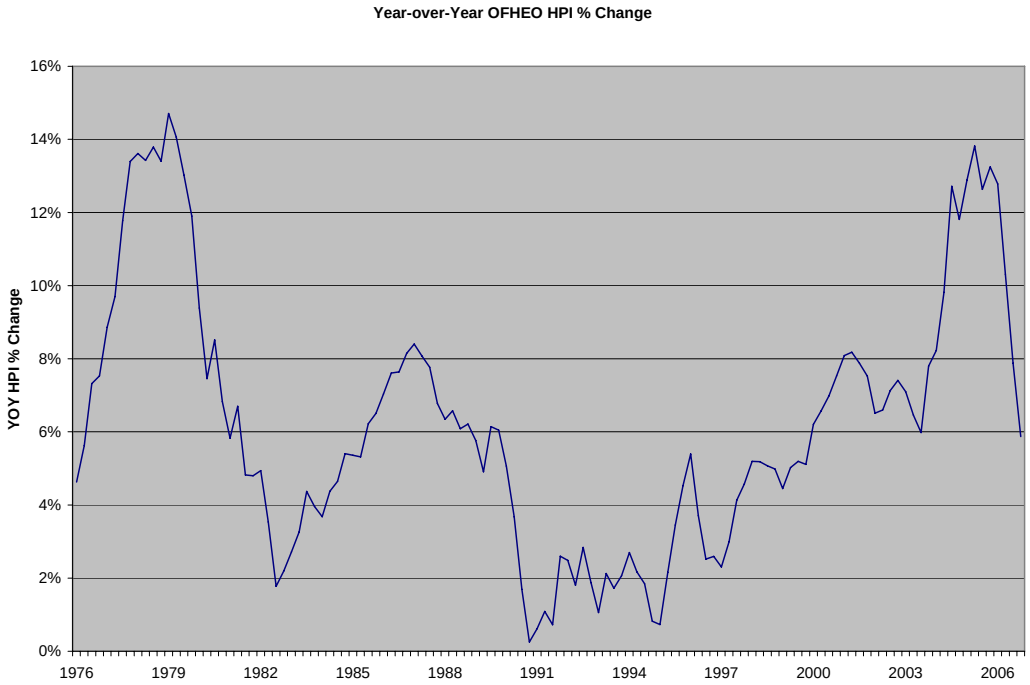
(Note: risk weights are estimated using the worst possible situation for a given LTV/FICO combination. For example, the risk weight for FICO<620 and LTV>95 is calculated using a FICO=560 and an LTV=110)

The implied risk weights support our concerns regarding the use of only LTV:

- *The table demonstrates that a 20% risk weight is too high for a loan with an LTV below 60%, regardless of borrower creditworthiness*

- *It supports the conclusion that an LTV range of 60% to 80% is too broad. The calculated risk weights for the 60% to 70% LTV band range from 0% to 39% while those for 70% to 80% LTV band range from 13% to 69%*
- *It illustrates that within any LTV range there is significant differentiation of credit risk, and that the proposed Basel 1A risk weights are aligned more closely with the lower FICO ranges than with the higher FICO ranges. This supports the use of FICO scores to further differentiate credit risk and better align risk weights with underlying exposures*

Separately, we believe that risk assessment should reflect the most up-to-date information about the borrower and the loan. Accordingly, we recommend that both home values used in the calculation of LTV and borrower FICO scores be updated annually. We believe that institutions should be allowed to update housing values, which is relatively easily accomplished by using the publicly available Office of Federal Housing Enterprise Oversight (OFHEO) housing price index (HPI). Home value is a critical component in assessing the true credit risk of a mortgage loan, and the use of out-of-date home values will overstate credit risk during periods of housing price appreciation and understate credit risk during periods of housing price decline. At the national level, the US has never experienced a year-over-year decline in house values (see graph), which means historically housing appreciation has reduced overall credit risk within the mortgage industry. The converse could also occur and in declining home price environments ignoring HPI could lead to an undercapitalization of risks.



Operationally, the Agencies should also consider standardizing the use of FICO scores. For example, the Agencies should consider the following recommendation for determining FICOs at origination:

- *If the borrower has a score from the three bureaus we recommend using the middle score and if there are only two then we recommend taking the lower of the two*
- *In case of multiple borrowers we recommend using the lowest score across all borrowers*
- *As stated above, we recommend that borrower credit scores be updated annually*

Question 8: The Agencies seek comment on this treatment and other methods for risk weighting these privately-issued mortgage-backed securities, including the appropriateness of assigning risk weights to these securities based on the risk weights of the underlying mortgages as determined under Table 3.

We feel that requiring banks to look at the composition of the underlying loans would be burdensome and that existing risk-based capital rules are adequate for capturing the risk of these MBS. For rated securitizations, we continue to support the use of NRSRO ratings.

Question 11: The Agencies request comment on all aspects of PMI including, whether PMI providers must be non-affiliated companies of the banking organization. The Agencies also seek comment on the treatment of PMI in the calculation of LTV when the PMI provider is not an affiliate, but a portion of the mortgage insurance is reinsured by an affiliate of the banking organization.

From time to time industry participants will acquire supplemental pool insurance to credit enhance mortgage investment portfolios. CFC strongly believes that the Agencies should take into consideration the economic benefits associated with pool-level mortgage insurance (MI) and work to develop an approach to provide regulatory capital relief for such policies.

Unlike loan-level MI, pool-level MI absorbs losses on a portfolio basis, which means the benefit associated with pool-level MI cannot be captured by simply adjusting LTVs at the loan-level as is done to calculate the benefit of loan-level MI. The following section describes how CFC proposes to recognize the risk-transfer benefits associated with pool-level MI.

We separate our discussion of pool-level MI into the two most common forms, (1) ***first-loss MI*** *and (2)* ***mezzanine MI****. In first-loss MI policies the purchaser has no deductible and the guarantor (seller) covers all losses up to a pre-defined limit. Mezzanine MI policies have a deductible (MI deductible), typically a percentage of covered exposures, that the institution must cover before MI coverage is triggered.*

A. First-Loss Mortgage Insurance

With first-loss MI, if the policy coverage amount equals or exceeds the pool-level regulatory capital,[4] then the value of the pool-level regulatory capital would be deducted from total regulatory capital. If the coverage amount of the pool-level MI is less than the pool-level regulatory capital, then the value of the protection amount would be deducted from total regulatory capital. Separately, the value of the deduction must be risk-weighted as a direct counterparty exposure and added to regulatory capital.

In addition, some pool-level MI policies combine aggregate loss limits with loan-level limits (e.g., provide loss coverage down to an LTV of 60%). For policies containing loan-level terms, additional considerations must be made to recognize the risk transfer benefit of such policies. (Refer to appendix 1 for illustrative examples of the proposed calculations.)

B. Mezzanine Mortgage Insurance

Unlike first-loss pool policies where the value of the insurance is easily quantified, the complex features of mezzanine policies make quantification and determination of the associated risk-transfer benefit more difficult. Under mezzanine policies the purchaser must cover a pre-determined amount of losses before the MI is liable, which effectively creates separate tranches with different underlying credit risk.

Regarding the calculation approach, if the value of the policy equals or exceeds the difference between pool-level regulatory capital and the MI deductible, then the difference between pool-level regulatory capital and the MI deductible may be deducted from total regulatory capital. If the value of the mezzanine MI is less than the difference between pool-level regulatory capital and the MI deductible, then the value of the mezzanine MI may be deducted from total regulatory capital. Separately, the value of the deduction must be risk-weighted as a direct counterparty exposure and added to regulatory capital. (Refer to appendix 1 for detailed examples of the proposed calculations.)

In this approach, there is no differentiation between credit risk associated with the MI deductible (i.e., first-loss piece) and the uncovered regulatory capital (i.e., senior piece). Stated differently; consider two pool policies, one where the insurance company covers 1% to 4% in losses and another where the coverage is 2% to 5%. Both policies cover 3% in aggregate losses, however, the first policy has a 1% first loss piece where the second policy has a 2% first loss piece. Under the basic approach both pool policies receive the same regulatory capital.

[4] For the purposes of estimating the risk-transfer benefits, we define the notion of pool-level regulatory capital that refers to the implied level of Basel 1A regulatory capital associated with a specified pool of loans.

In summary, we strongly urge the Agencies to allow institutions to recognize the economic risk-transfer benefits associated with first-loss pool policies. We believe that the calculations for such policies are relatively straight forward and would not add a significant operational burden. At the same time, while we recognize the difficulties in creating a simple framework for providing capital relief for mezzanine pool policies, we encourage the Agencies to review our proposal and to continue to develop an approach for recognizing the risk-transfer benefits embedded in these policies.

Question 12: The Agencies seek comment on the proposed risk-based capital treatment for all mortgage loans with non-traditional features and, in particular the proposed approach for mortgage loans with negative amortization features. The Agencies also seek comment on whether the maximum contractual amount is the appropriate measure of the unfunded exposure to loans with negative amortization features. The Agencies seek comment on whether the unfunded commitment for a reverse mortgage should be subject to a similar risk-based capital charge.

Negative amortization occurs, for example, when the borrower pays the minimum payment on a pay-option loan and this minimum payment is not enough to pay the amount of interest due for the month. The deferred interest results in negative amortization, that is capped at up to 15% of the original loan amount.

As discernible from public filings, negative amortization expressed as a percentage of the original loan amount has been approximately 2.0%. For the typical pay-option loan with a 15% negative amortization cap, the 50% credit conversion factor (CCF) proposed in Basel 1A implies an average negative amortization amount of 7.5% of the original loan value, which would appear to be overly conservative given our historical experience. Accordingly, we request the Agencies consider lowering the CCF to 20%, which would still result in a conservative 3.0% of the original loan amount being capitalized.

In making this decision, the Agencies should take into consideration the inherent features of pay-option loans that serve to restrict the build-up of negative amortization. For example, when compared to unfunded HELOC commitments that can ramp up instantaneously, the ramp up of pay-option ARM commitments are limited by the agreed-upon payment options and amount of the minimum payment. Another constraining feature is that the minimum payment on pay-option loans is recalculated every 12 months, effectively increasing the minimum payment (in a rising rate environment) and slowing the accumulation of negative amortization. Thus negative amortization build-up is more predictable and more controlled than that of a HELOC commitment.

Based on these attributes and CFC's experience with negatively amortizing loans, we request the Agencies to strongly consider reducing the credit conversion factor on the negative amortization unfunded exposure from 50% to 20%.

Question 13: The Agencies request comment on the appropriateness of the proposed risk-based capital treatment for HELOCs including the burden of adjusting LTV as the borrower utilizes the HELOC.

With regards to adjusting the LTV as the HELOC draws, we think the proposal is acceptable as it stands and is not overly burdensome.

However, the proposed method for calculating the combined LTV for the unfunded portion of stand-alone junior liens, as described in section D (i.v) is extremely burdensome. For stand-alone junior liens, we do not always have information about the negative amortization feature of the first lien since we do not necessarily hold the first lien loan.

We suggest the Agencies remove from the proposal the provision wherein negative amortization of the first lien impacts the calculation and simplify the combined LTV calculation for stand-alone junior liens as follows:

Funded junior lien combined LTV = (Funded portion of junior + first mortgage principal balance as of the junior loan fund date) / property value

Unfunded junior lien combined LTV = (Undrawn portion of HELOC + drawn portion of HELOC + first mortgage principal balance as of the junior loan fund date) / property value

Question 14: Accordingly, the Agencies seek further comment on all aspects of the use of LTV and borrower creditworthiness to determine the risk weight for a junior lien mortgage.

Reference our table from question 7. We favor the inclusion of borrower creditworthiness in addition to CLTV in determining the risk weights for junior mortgages.

Question 15: The Agencies continue to seek comments on an alternative approach that would apply a single CCF of 20 percent to all commitments, both short- and long-term (that are not unconditionally cancelable), and the advantages and disadvantages of such an approach.

CFC supports the application of a single credit conversion factor of 20% for both short- and long-term commitments that are non-cancelable.

Question 19: To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the

Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

CFC supports the full implementation of the 2004 Framework, with all options available (Standardized, Foundation IRB, and Advanced IRB) subject to supervisory approval.

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

We support the adoption of Basel 1A as modified above with the recommended changes, and in the absence of those recommended changes, we support the standardized approach.

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

As discussed earlier, in our combined response to questions 7, 9 and 10, we find the risk weights associated with the proposed LTV slopes to be overly punitive and accordingly, we would only suggest including operational risk charges if, and only if, the Agencies decide to lower the risk weights associated with the credit risk portion of the proposal.

In considering the three methods set forth in Basel II, we return to the Agencies' express desire for "revisions to the existing risk-based capital framework that would enhance its risk sensitivity without unduly increasing regulatory burden." The operational risk component of Basel II varies greatly in its regulatory burden. While the Basic Indicator and Standardized Approaches can generally be implemented without unduly increasing regulatory burden, the same cannot be said for the Advanced Measurement Approach.[5] *Similarly, at least with respect to the Basel 1A proposals, the well-known increase in regulatory burden surrounding*

[5] Cf. M. Moscadelli, "The Modelling of Operational Risk: Experience with the analysis of the data collected by the Basel Committee," *Banca d'Italia, Termi di discussione del Servizio Studi,* **no. 517**, 41 2004.

the Advanced Measurement approach would seem to be at odds with the Agencies' goal of not unduly increasing regulatory burden. Consequently, we suggest that if the Agencies were to take into consideration modifications to the credit risk component as recommended in this letter, then the inclusion of the Basic Indicator or Standardized Approaches to Basel 1A would be appropriate.

Question 22: What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?

In order to increase the risk sensitivity of the existing risk-based capital rules while minimizing the overall burden to banking organizations, CFC recommends that the Agencies consider allowing banks to utilize widely available mortgage credit risk models developed by the rating agencies for use in rating residential-mortgage-backed securities (RMBS).[6]

The credit risk capital levels produced by the rating agencies are appropriately risk sensitive for different mortgage assets. One key advantage is consistency; the rating agency models would offer a consistent and risk-sensitive view of credit risk across a wide spectrum of mortgage portfolios across all banks.

CFC recommends that the Agencies take these rating agency models into consideration as an effective solution for developing a more risk-sensitive approach to evaluating mortgage credit risk.

[6] Moody's, Standard and Poor's and Fitch all produce models for use in rating residential-mortgage-backed securities and all are designated as nationally recognized statistical rating organizations by the SEC.

Appendix 1 (Question 11)

Illustrative Example Involving First-Loss Mortgage Insurance – Partial Coverage
Assume an investing bank insures a $100 million portfolio of loans where the AAA-rated insurer agrees to cover all losses from 0-4%. Also, assume that the regulatory capital for the associated pool of loans is $5 million ($100m*50%RW*10%). The calculation of the capital requirement for the pool is illustrated below:

Step 1: Calculate the value of the pool-level MI

= $100m * 4% = **$4m**

Step 2: Calculate uncovered regulatory capital

Pool-level regulatory capital = $5m
Pool-level MI = $4m

=$5m-$4m = **$1m**

Step 3: Calculate the capital charge for the direct exposure to the AAA-rated MI

Exposure = $4m
Direct exposure risk weight = 20%
Regulatory capital = 10%

=$4m * 20% * 10% = **$0.08m**

Step 4: Calculate capital requirement for the pool

Uncovered regulatory capital = $1m
Direct exposure capital = $0.08m

Pool capital requirement = $1m + $0.08m = **$1.08m**

First-Loss MI Policies with Loan-Level Limits

If the policy contains loan-level coverage limits, the institution must perform additional calculations to determine the risk transfer benefit of the policy. First, the institution must calculate the pool-level regulatory capital as outlined in section II.B of Basel 1A. Separately, the institution must calculate the pool-level regulatory capital as if all underlying loans were

capped at the loan-level limit of the MI policy (e.g., LTV of 60%). The difference between the two regulatory capital calculations is the maximum value of any risk transfer benefit. If the value of the policy equals or exceeds the difference, then the institution may deduct that amount from total regulatory capital. If the value of the MI policy is less than the difference, then the institution may deduct the value of the MI policy from total regulatory capital. Separately, the value of the deduction must be risk-weighted as a direct exposure and added to regulatory capital.

Illustrative Example Involving Mezzanine MI

Assume an investing bank insures a $100 million portfolio of loans where the AAA-rated insurer agrees to cover losses from 1-4%, and the bank will cover losses from 0-1% (MI deductible). Additionally, assume that the regulatory capital for the associated pool of loans is $5 million ($100m*50%RW*10%). The calculation of the capital requirement for the pool is illustrated below:

Step 1: Calculate the value of mezzanine MI

Mezzanine MI = $100m * 3% = **$3m**

Step 2: Calculate uncovered regulatory capital

Pool-level regulatory capital = $5m
Mezzanine MI = $3m

=$5m-$3m = **$2m**

Step 3: Calculate the capital charge for the direct exposure to the AAA-rated MI

Exposure = $3m
Direct exposure risk weight = 20%
Regulatory capital = 10%

=$3m * 20% * 10% = **$0.06m**

Step 4: Calculate capital requirement for the pool

Uncovered regulatory capital = $2m
Direct exposure capital = $0.06m

Pool capital requirement = $2m + $0.06m = **$2.06m**

Mezzanine MI – Advanced Approach

Included below are the details for an alternative approach (the 'advanced approach') to mezzanine pool insurance. The advanced approach is more complex than the previous approach and should be viewed as a potential construct for differentiating credit risk with mezzanine insurance.

There are several preliminary calculations required under the advanced approach.

1. The institution must calculate the value of the MI deductible, MI coverage, and any uncovered regulatory capital using the MI coverage terms (e.g., 1-4%).

2. Coverage ratios must be calculated by dividing the three values in step one by the pool-level regulatory capital amount, and then UPBs for each piece must be calculated by multiplying the total pool UPB by the respective coverage ratios.

3. The institution must calculate risk-weighted asset values for all three pieces. The MI deductible piece must contain the highest risk-weighted loans, the uncovered regulatory capital piece must contain the lowest risk-weighted loans, and the MI coverage piece will contain the remaining loans.

4. The MI coverage RWA must be converted to a counterparty RWA by applying the 10% regulatory capital charge, and then apply the risk weight associated with the rating of the MI company (e.g., 20% RW for a AA-rated MI).

5. Finally, take the sum of the risk-weighted asset amounts and multiply by the appropriate regulatory capital percentage. (Refer to below example for clarification of required calculations).

Illustrative Example Involving Mezzanine MI with 1-4% Coverage – Advanced Approach

Assume an investing bank insures a $100 million portfolio of loans where the AAA-rated insurer agrees to cover losses from 1-4% and the bank is responsible for covering losses from 0-1% (MI deductible). Also, assume that the regulatory capital for the associated pool of loans is $5 million (assume that $62.44m is risk-weighted at 35% and $37.56m at 75%). The calculation of the capital requirement for the pool is illustrated below:

Step 1: Calculate the value of MI coverage

MI Deductible = $100m * 1% = **$1m**
MI Coverage = $100m * 3% = **$3m**
Uncovered Reg Cap = $5m - $3m - $1m = **$1m**

Step 2: Calculate coverage ratios and associated UPBs

MI Deductible Ratio = MI Deductible / Pool-level Reg Cap = $1m/$5m = **20%**
MI Coverage Ratio = MI Coverage / Pool-level Reg Cap = $3m/$5m = **60%**
Uncovered Ratio = Uncovered Reg Cap / Pool-level Reg Cap = $1m/$5m = **20%**

MI Deductible UPB = $100m * 20% = **$20m**
MI Covered UPB = $100m * 60% = **$60m**
Uncovered UPB = $100m * 20% = **$20m**

Step 3: Calculate the risk-weighted asset amount associated with each of the three portions. (Note: The MI deductible portion must contain the highest risk-weighted loans within the pool, the uncovered portion must contain the lowest risk-weighted loans within the pool, and the MI covered portion contains the remaining loan balance.)

MI Deductible RWA = $20m * 75%RW = **$15m**
MI Covered RWA = ($42.44m * 35%RW) + ($17.56m * 75%RW) = **$28.02m**
Uncovered RWA = ($20m * 35%RW) = **$7m**

Step 4: Calculate counterparty capital component

Counterparty risk weight = 20%
Regulatory Capital = RWA * 10%

MI Covered Capital = $28.02m * 10% = **$2.8m**
Counterparty Capital = $2.8m * 20% * 10% = **$0.056m**

Step 5: Calculate total pool-level capital

MI Deductible Capital = $15m * 10% = **$1.5m**
Counterparty Capital = **$0.056m**
Uncovered Capital = $7m * 10 % = **$0.7m**

Total Pool-Level Capital = $1.5m + $0.056m + $0.7m = **$2.23m**

Illustrative Example Involving Mezzanine MI with 2-5% Coverage – Advanced Approach
Assume an investing bank insures a $100 million portfolio of loans where the AAA-rated insurer agrees to cover losses from 2-5% and the bank is responsible for covering losses from 0-2% (MI deductible). Also, assume that the regulatory capital for the associated pool of loans is $5 million (assume that $62.44m is risk-weighted at 35% and $37.56m at 75%). The calculation of the capital requirement for the pool is illustrated below:

Step 1: Calculate the value of MI coverage

MI Deductible = $100m * 1% = **$2m**
MI Coverage = $100m * 3% = **$3m**
Uncovered Reg Cap = $5m - $3m - $2m = **$0m**

Step 2: Calculate coverage ratios and associated UPBs

MI Coverage Ratio = MI Coverage / Pool-level Reg Cap = $3m/$5m = **60%**
MI Deductible Ratio = MI Deductible / Pool-level Reg Cap = $2m/$5m = **40%**
Uncovered Ratio = Uncovered Reg Cap / Pool-level Reg Cap = $0m/$5m = **0%**

MI Deductible UPB = $100m * 40% = **$40m**
MI Covered UPB = $100m * 60% = **$60m**

Step 3: Calculate the risk-weighted asset amount associated with each of the three portions. (Note: The MI deductible portion must contain the highest risk-weighted loans within the pool, the uncovered portion must contain the lowest risk-weighted loans within the pool, and the MI covered portion contains the remaining loan balance.)

MI Deductible RWA = ($37.56m * 75%) + ($2.44m * 35%) = **$29.024m**
MI Covered RWA = ($60m * 35%) = **$21m**

Step 4: Calculate counterparty capital component

Counterparty risk weight = 20%
Regulatory Capital = RWA * 10%

MI Covered Capital = $21m * 10% = **$2.1m**
Counterparty Capital = $2.1m * 20% * 10% = **$0.042m**

Step 5: Calculate total pool-level capital

MI Deductible Capital = $29.024m * 10% = **$2.9m**
Counterparty Capital = **$0.042m**
Total Pool-Level Capital = $2.9m + $0.042m = **$2.94m**