Mortgage Insurance Companies of America

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Docket No. 06-09
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Docket No. R-1261
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Via email to Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
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Attention: No. 2006-33
Via email to regs.comments@ots.treas.gov

RE: Risk- Based Capital Standards: Advanced Capital Adequacy Framework and Market Risk

Ladies and Gentlemen:

The Mortgage Insurance Companies of America (MICA) is pleased hereby to comment on the notice of proposed rulemaking (NPR) on the U.S. version of the Basel II rules. We have commented on the international consultative papers and the U.S. advance notice of proposed rulemaking because we strongly concur with the regulators' view that regulatory capital should align to the greatest possible extent with economic capital. We believe that many of the high-risk mortgage products grew exponentially in the last few years in part because regulatory capital fails to capture these risks when these loans are

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held in portfolio or structured into the secondary market. Your agencies have rightly responded to the growth of high-risk, non-traditional mortgages with the 2006 guidance in this arena [71 FR 58609]. However, we believe that the capital provisions currently applied to non-traditional mortgages fails to reflect the higher risk as highlighted by significant and ongoing market developments.

Indeed, it may be appropriate for the agencies to consider advanced risk-based capital (RBC) requirements for non-traditional mortgages on a stand-alone basis as the Basel II process continues. By their terms, non-traditional mortgages pose risks to the borrower and the holder of the mortgage that are not evident in more traditional products. As the agencies themselves have determined, these mortgages have become a growing portion of the residential mortgage marketplace which is currently beginning to experience weakening house price growth in several areas of the country. Non-traditional mortgages are proving more vulnerable to the stresses associated with flat to falling house prices and deserve separate capital treatment.

There is also a significant chance that your agencies will not be able to complete a final rule by the June 30 deadline tentatively set as the date by which a final rule must be in place for the parallel runs to begin in 2008. The longer the delay, the greater the incentives for regulatory-capital arbitrage in stressed conditions such as those now evident in some segments of the U.S. mortgage market. This issue is, of course, also addressed in the Basel IA NPR, on which MICA has today also filed comments.

Below, we provide comments on both issues specific in the NPR to mortgage insurance (MI) and to the larger thrust of the Basel II NPR. In summary, MICA comments are as follows:

- We concur with and appreciate the express discussion of MI as a form of credit risk mitigation (CRM). In sharp contrast to other forms of CRM, MI is extensively regulated, well capitalized, and has a demonstrable history of honoring claims without litigation risk to the bank or mortgage investor. Based on this, we not only support the proposed treatment of MI, but also recommend that the proposed 10% loss-given-default (LGD) floor not apply when qualified MI is in place. We support the qualifications proposed for MI providers, which correctly focus on claims-paying ratings, not those applicable to long-term debt.

- MICA continues to emphasize the importance of ensuring that risk-based capital (RBC) weightings are based on reliable historical data over the full spectrum of the business and macroeconomic cycle. This is particularly important for mortgages, as there are very limited data available for many new mortgage structures. We strongly caution against over-reliance on credit scores, which have shown themselves as poor predictors of default rates under stress and are largely unproven when applied to a wide range of new mortgage products. New data analysis supporting MICA's concern regarding credit scores are provided below. MICA supports the proposed use of supervisory

loss-given-default ratios unless a bank's stress testing and A-IRB methodology have a demonstrable record in accounting for stress over at least a ten year historical cycle with full supporting data.

- The final rule should specify clear, tough RBC treatment for credit exposures lacking adequate data for a reliable weighting to avoid creation of a regulatory capital incentive against effective data collection and analysis for high-risk exposures. We recommend that a guiding principal for the banking agencies should be that they provide capital relief on insured high LTV loans that corresponds to the depth of coverage obtained by the bank on these loans. Thus, as the depth of coverage increases and effectively lowers the risk inherent in the initial LTV of the loan, the capital relief obtained for this coverage should correspondingly increase.

- If the regulators decide on a standardized option, then we urge consideration of the clearly differentiated risk weightings proposed under Basel IA rather than the discretionary, unspecified imposition of higher risk weightings for higher risk mortgages. Without a clear standard set by rule, significant differences between agencies could occur with undesirable competitiveness implications. MICA believes the proposed risk weightings under Basel IA provide a clear framework for the standardized option that should be adopted if the standardized option is made available.

Our comments are detailed and include extensive presentation of relevant data. We regret the complexity of this presentation, but have provided it because of the critical importance of ensuring correct RBC treatment for bank mortgage obligations. The most recent data available from the FDIC indicates that mortgages for one-to-four-family residences accounted for 18.3% of total assets at all insured depositories at the close of the fourth quarter of 2006.[1] Of course, many institutions – especially smaller ones and savings associations – have mortgage concentrations far in excess of this number. It is, thus, critical to get mortgage RBC right and to do so as quickly as possible.

I. Treatment of Mortgage Insurance

The economics of the residential and secondary mortgage markets, the clear and binding legal and contractual obligations of mortgage insurers and the nature of residential mortgage defaults have resulted in a system in which private mortgage insurers pay all valid claims in full and on a timely basis. It is for this reason that the NPR rightly proposes express treatment for mortgages covered by private mortgage insurance (MI) and why MICA urges the agencies to retain this treatment in the final rule.

As a matter of law and contract, holders of mortgages protected by MI can rely on the MI company to meet its obligations even though the holder of the mortgage is often

[1] *FDIC Quarterly Banking Profile*, Fourth Quarter 2006.

not the originator of the loan nor did it negotiate the terms of the insurance coverage. Moreover, the event that triggers the MI company's obligation to pay the holder of the mortgage is borrower default on the underlying mortgage -- an obligation that is clearly defined in all MI agreements and in courts of law as an obligation without legal ambiguity. Thus, when a financial institution holding a mortgage with MI makes a claim, the mortgage insurer pays it except in the negligible number of cases of fraud. Additionally, MI provides first loss coverage and other features of insurance backed by the full claims-paying ability of the MI company. With MI coverage there is none of the uncertainty associated with surety bonds or other forms of corporate credit risk mitigation (CRM), nor any of the contractual and infrastructure uncertainties associated with credit derivatives.

All mortgage insurance companies are AA-rated or better as claims-paying entities. MICA believes that this claims-paying related rating, not that which may be applicable to any long-term debt, is the appropriate measure for eligible MI in the Basel II rules, and we support the NPR's treatment in this regard. Even though an MI company with a AA claims-paying rating may have the same senior long-term debt rating as a non-insurance A-rated company, its claims-paying ability is higher. This is because any guarantee offered by the non-insurance A-rated company will be treated the same with all other creditors in the event of a default. However, for an MI company, all debt, including senior long-term debt, is subordinated to the interests of the policyholders. Consequently, there is less risk that MI policyholders will not be paid as compared to the risk associated with a normal corporate guarantee.

All MIs are also subject to strict state insurance regulation that ensures full compliance with terms and conditions governing prompt payment of lender claims. MIs carry the highest capital of any type of insurance firm, and the rating agencies rate MIs using rigorous stress tests covering a ten-year period. Thus, there is little risk of default by an MI company on its obligation to pay the insured even under catastrophic risk scenarios – a contention demonstrated by the performance of the MI industry even under the extreme stress on housing finance during the mid-1980s. Thus, MI has several factors that clearly distinguish it from other forms of CRM:

- the amount of protection and the premium, are firmly established at the initiation of the insurance policy and are not subject to renegotiation;

- full rights related to MI are transferred with the underlying asset without any subsequent contractual negotiations that could reduce the value of the credit risk mitigation provided by the MI;

- the point at which MI may be terminated is based solely on the current loan-to-value ratio, not on extraneous risk factors such as a borrower's credit or market conditions. Thus, there is no risk that the MI will be cancelled or compromised if a borrower's risk profile increases due to new factors (e.g., unemployment or home price depreciation);

- the event that triggers MI and the amount paid are not subject to after-the-fact negotiation, except in cases in which a lender may have engaged in fraud or under comparable circumstances that do not undermine the value of this form of CRM. This is in sharp contrast to other CRM, where post-claim negotiations and non-payment are common; and

- by law, MIs are not allowed to invest premium revenues in single-family residential mortgage-related investments. Thus, during periods of significant house-price deflation, the ability of the MI to pay its claims in full is not compromised by a double exposure to the health of the residential mortgage market. This allows MIs to serve as CRM protecting the lender from double default, protection often not available with other forms of mortgage-related CRM.

II. Inappropriateness of 10% LGD Floor

All of the factors noted above associated with the claims paying ability of MI make the proposed treatment in the NPR wholly warranted. However, these factors also argue against the proposed 10% LGD floor as it would be applied for loans backed by private MI. MICA urges that this floor be eliminated to ensure regulatory-capital incentives align with the agencies' risk-management objectives.

In our previous comment letters, MICA has presented data that estimated the average loss-given-default (LGD) to insured mortgage holders after benefit of MI payments. That data reflected the distributions of net salvage values incurred over the 1990-2003 period assuming standard MI coverage levels. The analysis showed that generally the average net LGD <u>after</u> MI ranged between 4.6% and 7.6%. Thus, the proposed floor obviates some of the RBC benefit associated with credit risk mitigation (CRM) and so may discourage core banks from making full use of CRM. This would not only increase credit risk, but also worsen concentration risk at core banks with significant mortgage obligations. If the LGD floor is not eliminated, then the Pillar 2 standards and associated supervisory guidance should make clear that banks with large books of mortgages must carry additional concentration RBC when MI is curtailed for any reason.

MICA understands that following several international lender surveys, Basel Committee participants became concerned over the fact that recent residential loan performance reflected the effects of robust economies, booming residential markets and low interest rates. Committee members feared that LGD, one of the key inputs to the IRB equations utilized to estimate minimum residential loan capital, would be seriously biased downward, resulting in lower than prudent levels of capital for residential mortgage loan risk. To address this concern the Committee proposed the institution of a 10% LGD floor on all mortgage credit risk. While the measure is certainly simple and easy to implement, it does very little to address the Committee's appropriate concerns that reliance on recent experience would result in a seriously low estimate of mortgage credit risk.

In the US market, most of the LGD risk comes from loans that are between 75% and 100% LTV. If we assume that, as a result of above-average recovery rates on foreclosed properties, for all classes of original LTV the LGD rates were half the long-run averages, then a 10% floor only affects loans with LTVs less than 75%. The floor does nothing to correct an assessment of 15% LGD on a 100% LTV loan even though the long-run average for such an exposure is likely in excess of 40%. The 10% floor essentially only raises the LGD on the loans with the lowest average PD while it does nothing to prevent a severe underestimation of the higher LTV loans with substantially higher PDs.

While MICA recognizes that the proposal for the 10% floor was given by the Basel Committee as a "conservative measure", the rules also permit each government to impose rules that may be considered more conservative if the situation merits such a decision. MICA strongly encourages the U.S. Committee to consider the substitution of a maximum recovery value percentage for residential property as a more flexible and appropriate means of assuring appropriate stress LGD floors for all LTV levels. The largest driver in determining loss given default on a residential mortgage is the recovery value of the foreclosed property relative to the original stated value. Based on long-run average data assembled by MICA, the average recovery value is roughly 72% of the original value.[2] Under an "A" stress event, consistent with stress required to achieve a 2.8% capital requirement for 80 LTV loans, the average stress recovery value percentage is 65%. By matching this percentage against the ratio of the defaulted loan amount plus back interest and legal and foreclosure costs divided by the stated original property value one can determine the appropriate floor stress LGD required for a given range of LTV loans.

MICA would then suggest that once the appropriate level of gross minimum capital is determined that any approved CRM be allowed to function as intended with no further artificial restrictions. For example, if the gross stress LGD on a 90% LTV loan is determined to be 34%, and the benefits of an MI policy are 32%, that appropriate net LGD number is then 2%, not 10%.

III. Mortgage Credit Risk-Based Capital

As noted, MICA strongly endorses the intent of the advanced internal ratings-based (A-IRB) approach for mortgage obligations included in the NPR. However, we are concerned that the proposed methodology could lead banks to over-rely on credit scores which have proven not to be predictive of PD or LGD during periods of stress. Setting risk weightings based on over-reliance on credit scores or without adequate stress testing and historical data will undermine the intent of the new capital framework and still permit

[2] In 2003 MICA provided data to Federal Reserve researchers examining models of mortgage portfolio performance developed to estimate stress loss levels and ensuing capital requirements. As part of that effort, the MICA group combined information on over 240,000 actual recovery values on defaulted loans between 1990 and 2002. Paul S. Calem and James R. Follain, *The Asset Correlation Parameter in Basel II for Mortgages on Single Family Residences*, Board of Governors of the Federal Reserve System, October 15, 2003.

regulatory-capital arbitrage. Below, we discuss each of these points, providing new data to support our concerns.

A. Credit Scores

MICA believes that credit scores are useful in modeling expected losses and for risk-based pricing under normal economic circumstances. However, historical experience and current experience in the subprime and non-traditional mortgage arena shows clearly that credit scores are not reliable predictors of probability of default (PD), loss given default (LGD) and unexpected loss under stress conditions. Institutions that over-relied on credit scores in underwriting their recent mortgage books have experienced painful and costly surprises. "What is now clear is that FICO scores are less effective or ineffective when lenders are granting loans in an unusually low interest-rate environment," Douglas Flint, HSBC's finance director, was quoted as telling investors in December.[3] While much more work needs to be done to determine the proper role of credit scores in underwriting residential mortgages, what is clear is that recent problems in the mortgage markets may, in part, relate to over-reliance by loan originators in the borrower's credit score and insufficient reliance on the historically important risk-indicator of initial loan-to-value (LTV) ratios as a major predictive factor in bank residential mortgage models as LTV ratios have historically proven more predictive during periods of stress.

Further, severe strains so far have occurred during periods of economic stability and only modest house-price declines (although these are, of course, beginning to worsen). When market stress occurs, even if not exacerbated by interest rate stress, MICA data demonstrate that credit cores are highly unreliable predictors of PD, with PD actually performing in highly unexpected ways.

In addition, the Basel IA NPR correctly notes numerous operational issues raised by use of credit scores. These include regional disparity, especially when borrowers are not geographically diverse; how often credit scores should be updated; and treatment of borrowers with multiple credit scores, loans with multiple borrowers with different probabilities of default, poor credit-report data, and individuals with insufficient credit history to calculate a probability of default.

The NPR requests comment on the use of both LTV and credit scores in setting minimum capital requirements. There are significant differences between LTV and credit scores and other borrower attributes. An argument can be made against treating FICO equivalently to LTV in setting minimum capital. Lower LTVs, or equivalently, higher MI coverage, provide additional equity protection that warrant direct dollar-for-dollar reductions in risk-based capital requirements. Although higher credit scores will imply relatively lower values of PD, they are not a direct substitute for lower LTVs or deeper MI coverage in offsetting unexpected losses (UL) and should not be treated as equivalent forms of protection.

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[3] FAULTY ASSUMPTIONS: In Home-Lending Push, Banks Misjudged Risk, Carrick Mollenkamp, *Wall Street Journal*, February 8, 2007.

B. Credit Scores as a Predictive Factor During a Period of Housing Market Stress

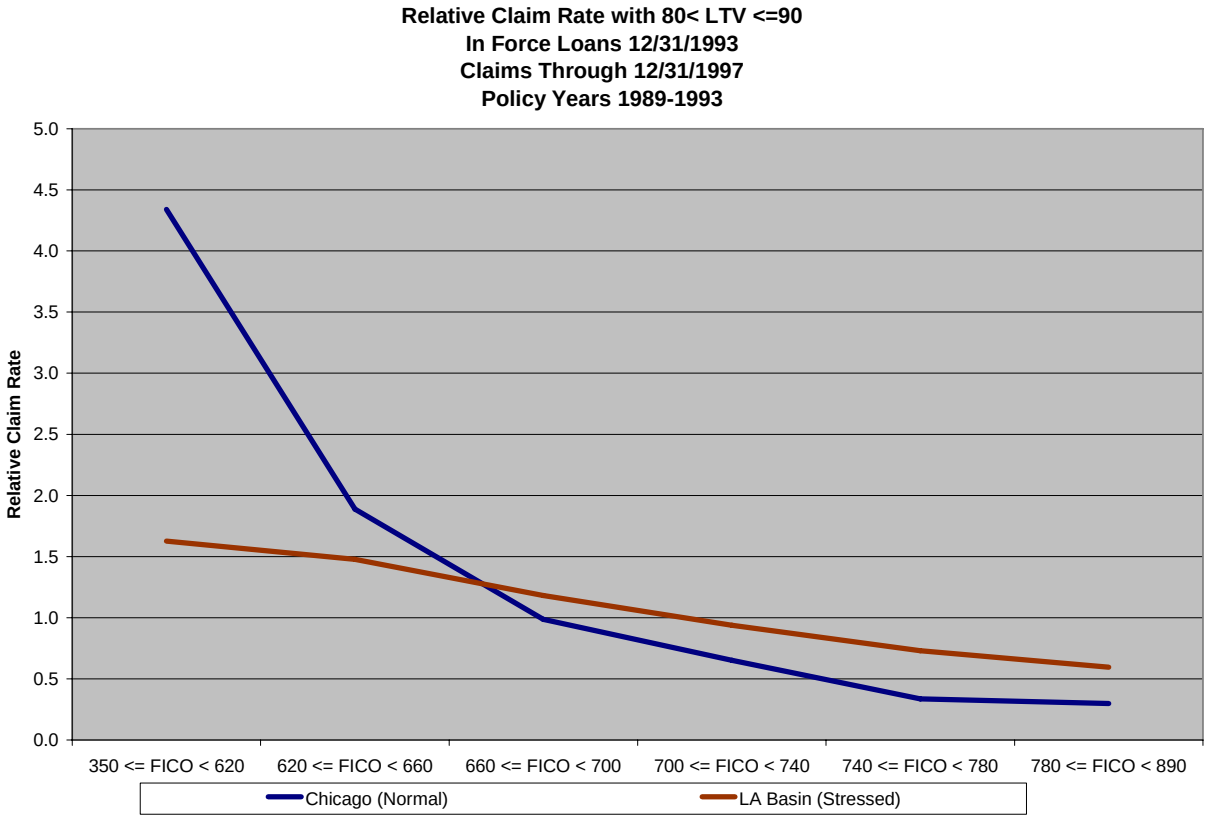
MICA members have analyzed their industry data and produced conclusive evidence that credit scores, while highly predictive of foreclosure rates under normal housing market conditions, lose much of their predictive power under stressed market conditions. Furthermore, the study shows that the impact of housing market stress overwhelms the impact of credit scores as a determinant of ultimate foreclosure rates.

The MICA study data consists of loans insured by four MICA member companies where MI coverage was in force as of December 31, 1993 in the greater Chicago and Los Angeles metropolitan areas. These two geographic markets were chosen to represent a "normal" housing market (Chicago, 3.7% average annual appreciation 1993Q4-1995Q4) and a "stress" housing market (Los Angeles, -4.0% average annual appreciation 1993Q4-1995Q4). In order to concentrate on the impact of credit scores, we limited the study to loans with initial LTV ratios above 80% but no higher than 90%. This range also contains the majority of the loans insured by MICA members during the study period. Additionally, all of the loans were underwritten to “prime” loan underwriting standards that existed at that time and all were fully documented. Importantly, at the time these loans were originated the borrower’s FICO score was not an underwriting criterion for a prime loan. However, each of the loans analyzed in this study had a known FICO credit score at or near the time of the loan’s origination. The population of these loans with known FICO scores includes origination years 1989 and later.

MICA grouped the loans according to FICO score ranges that are commonly used in the industry, measured the cumulative claim rate through the end of 1997, and compared the claim rates across FICO score ranges and the two markets to create relative claim rates. The definition of a mortgage insurance claim is sufficiently close to that of a foreclosure, that claim and foreclosure may be used interchangeably in this discussion.

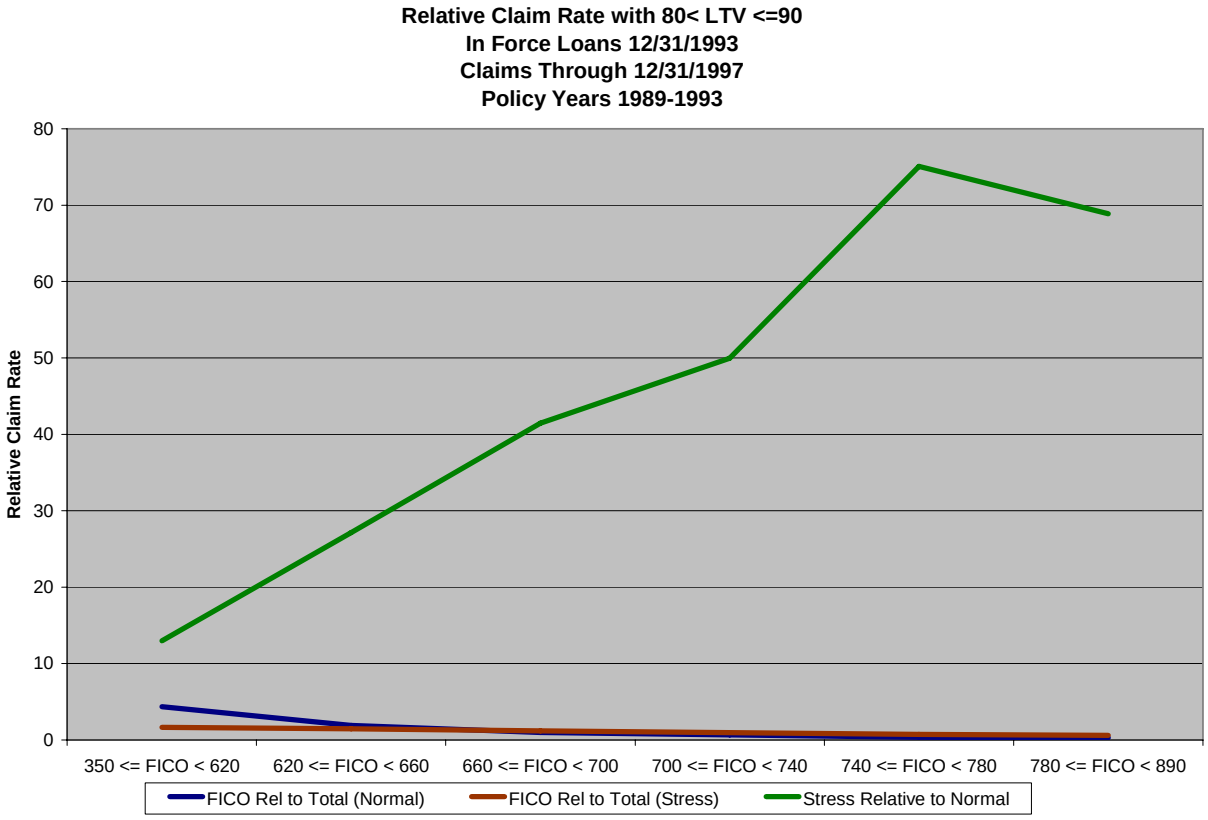
In Figure 1, we show the claim rate for each FICO range, relative to the overall claim rate for the market. In the normal market (Chicago), the lowest FICO range (<620) had a claim rate that was 4.34 times the overall claim rate for the market, while the claim rate for the highest FICO range (>=780) was 0.30 times the overall rate. In the stressed market (Los Angeles), the relationship between FICO and claim rate is noticeably weaker. The claim rate for the lowest FICO range is only 1.63 times the overall rate, and the claim rate for the highest FICO range is 0.59 times the overall rate.

Figure 1



While Figure 1 amply demonstrates the reduced importance of FICO scores in determining claim rates in a stressed housing environment, Figure 2 illuminates why this is the case. In Figure 2, we add to the previous graph the claim rate for the stressed market relative to the normal market for each FICO range. The claim rate in Los Angeles for loans with FICO scores less than 620 was 12.97 times the claim rate in Chicago for the same period. As FICO scores increase, the impact of stressed housing markets increases substantially. In the highest FICO range, where scores are 780 or greater, the claim rate in Los Angeles was 68.87 times the claim rate in Chicago. Clearly the impact of the stressed housing market makes the FICO impact all but vanish.

Figure 2



This last point cannot be overemphasized. Risk based capital is what lenders must hold to protect against unexpected risk. The data presented here starkly illustrates the conclusion that, while credit scores are highly correlated with expected risk, they have very little correlation with unexpected risk. Unexpected losses in mortgage lending are driven, more than anything else, by declines in home prices. Declining home values are a great equalizer in a mortgage portfolio, affecting all borrowers regardless of their prior credit history. Consequently, the gap between expected and unexpected foreclosure rates is actually significantly higher for borrowers with high credit scores. MICA concludes from this evidence that, while credit scoring is useful for pricing and reserving applications, it is not useful for setting capital requirements. As a result, we recommend that the regulators not include borrower credit scores in determining risk weights for mortgages.

Also, as the A-IRB formula for minimum capital on residential mortgages requires a fixed correlation factor of 15% when converting long-run average PDs and stress level LGDs into minimum capital, the formulas will fail to reflect the substantial differences in the stress multiples relative to expected PD levels of loans segmented by credit scores. This, in turn, will result in substantial shortfalls in prudent capital levels for high credit score/high LTV loan segments. Given this inflexibility of the A-IRB model, MICA strongly suggests US regulators not approve the use of LTV/credit score

segmentation of mortgage loans until the A-IRB model can be revised to such an adaptation.

C. Stress Testing

MICA strongly endorses the emphasis in the NPR on stress testing, but concurs that the Pillar 1 standards should also include a supervisory LGD unless an institution's stress tests have shown themselves to be fully robust and to include sufficient historical analysis. In its recent report on the Basel rules, the General Accountability Office (GAO) rightly emphasized the importance of historical data, noting that:

> [T]he appropriateness of the capital requirements generated by the A-IRB approach depends on the accuracy of parameter estimates, such as PD and LGD, which depend in part on the quality and comprehensiveness of the historical data that underlie the estimates. For portfolios with data that cover short time horizons or incomplete economic cycles, the capital required under the A-IRB approach will not necessarily accurately reflect the risk of credit losses from the asset because the more limited history may not be representative.[4]

As the credit score data above make clear, mortgages perform very differently under stress scenarios. Often, these do not occur for prolonged periods of time, such as has recently been evident in the many recent years of strong mortgage performance that preceded today's troubling numbers and sharp increases in delinquencies and foreclosures.

In the A-IRB, the institution establishes its own Probability of Default (PD) and Loss Given Default (LGD) through use of a five-year history for the performance of its proprietary mortgage book. The proposed minimum of a five-year period is very troubling. It is rare that one can view a full economic cycle in less than ten years -- let alone be assured of catching part of one in any consecutive five-year period. This is especially the case with mortgage defaults, which are often a lagging factor in economic cycles. Further, mortgage default rates can be dissociated from larger economic cycles, as is now becoming apparent in the United States. Recent quarters have shown sharp increases in mortgage delinquency and foreclosure rates even as overall economic conditions remain sound. Thus, it is critical not only to use long-term macroeconomic data to set A-IRB capital and stress test it, but also to ensure that mortgage scenarios are not overly dependent on larger macroeconomic factors but instead reflect specific mortgage-market experience relevant to the institution's underwriting standards and mortgage portfolio.

The chart below (Figure 3) illustrates the extremity of the last half-decade with respect to U.S. home price growth. From 2001Q1 to 2005Q4 only a handful of

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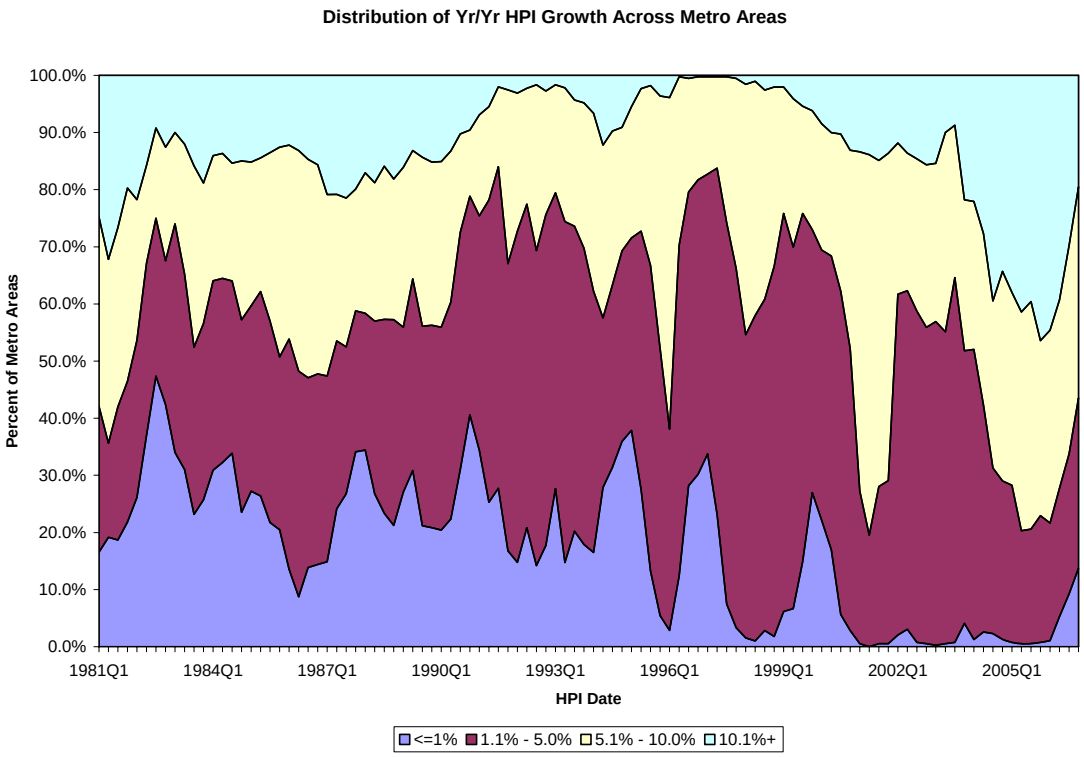
[4] *RISK-BASED CAPITAL: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework*, GAO-07-253, February 2007.

metropolitan areas experienced less than 1% growth in the OFHEO Home Price Index (HPI) over four quarters. At the peaks of the expansion, in 2001Q2 and 2005Q2, 80% of the metro areas experienced greater than 5% annual growth in home prices. The extent to which home price growth has permeated all regions of the country, and the amount of time over which it has occurred, is without precedent in the period for which the HPI is available.

Figure 3



This sustained, broad appreciation in housing has had a significant positive impact on the performance of mortgages in terms of PD and LGD. This impact has been very evident in high LTV loan performance as reported by the private mortgage insurance industry. Formed in 1973, MICA members have represented the entire private mortgage insurance industry. As part of its ongoing operations in representing these companies, MICA has served as a central information collection point for the benefit of its members in order to improve their ability to assess and analyze mortgage credit risk. To this end, members have contributed loan level performance information to form a national high LTV data bank. This performance data set can provide US regulators with invaluable information on the true long-run average performance parameters required by the proposed Basel II Accord.

Table 1

Average Annual PD Rates Over a Ten Year Period for Fixed Rate Loans Grouped By Five Origination Years

	90 LTV	95 LTV
1970-1999	**0.54%**	**1.02%**
1970-1974	0.21%	0.56%
1975-1979	0.27%	0.54%
1980-1984	**1.03%**	**2.95%**
1985-1989	0.69%	0.90%
1990-1994	0.59%	0.70%
1995-1999	0.30%	0.63%
1990-1999	**0.44%**	**0.67%**
1990-1999 as % 1970-1999	81.98%	65.35%
1995-1999 as % 1970-1999	**54.97%**	**62.26%**
Worst 5 Books 1980-1984	**1.03%**	**2.95%**

PD Calculated As Cumulative Number Of Claims Over Ten Years Divided By Sum Of Loans Outstanding at Beginning Of Each Period

Table 1 (above) shows average ten-year PD (default defined as existence of an MI Claim) rates for 90 LTV and 95 LTV fixed rate loans for five-year origination intervals. These data on all privately insured loans clearly show the impact of prolonged above-average home price appreciation on high LTV loan PDs during the 1990s. PD rates on high LTV loans for the 1990s have averaged well below the true long-run national average. Moreover, PDs for the last several years have been even further below the long-run average, running at 55% and 62% of 90 and 95 LTV long-run averages. As observed in models developed by the Federal Reserve,[5] estimates of long-run averages using data pulled primarily from 1991 through 1999 yield PD estimates that are consistent with the average for the 1990s and fall short of true long-run averages by more than 20%. Unless institutions have more than ten years of data, they will most likely fall short of true long-run average PD estimates.

[5] Calem and Follain, Op. Cit.

In order to study the impact of beneficial economic circumstances on LGD distributions, MICA members collected data representing over 240,000 loans that experienced a mortgage insurance claim after 1990. On each of these loans the insurer has an accurate assessment of unpaid principal and property value at the time of default. In many cases, the insurer has exact data regarding the net sale proceeds from disposition of the property. Thus, for each of these loans, MICA can determine a precise estimate of Loss Given Claim (LGC) and Loss Rate (loss amount divided by original loan amount).

It is important to distinguish between LGC and LGD, because the transition probabilities from default to claim vary substantially. The MI companies traditionally call the complement of this transition probability the cure rate. The most important driver of cure rate is LTV at the time of default. The relationship between LGC and LGD can be given as:

LGD = LGC * (1 - Cure Rate).

As Cure Rate approaches zero, LGD and LGC become equivalent. As Cure Rate approaches 100%, LGD approaches zero. The higher the Cure Rate, the lower is LGD relative to LGC.

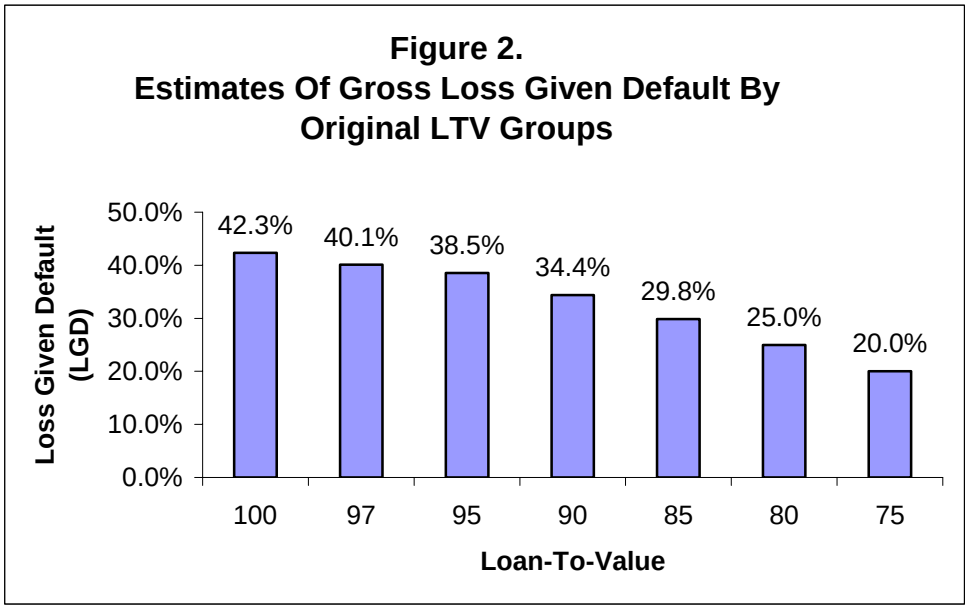
In Table 2, we show LGC rates by default year, relative to the period 1990-1994, for three levels of original loan-to-value (LTV) ratio. For each LTV group, loss rates have declined significantly over the period in which home price appreciation has been so strong. Loans with LTV ratios from 71% to 80%, for example, had a median LGC in 2000-2003 that was 53% of the level experienced from 1990 to 1994. High LTV loans, which tend to have higher losses even in good economic times, experienced lower but still significant declines in observed LGC.

Table 2

Average Loss Given Claim Rates

		Relative LGC	
Orig LTV	Deflt Year	Median	Mean
080	1990-1994	100%	100%
	1995-1999	80%	81%
	2000-2003	53%	63%
090	1990-1994	100%	100%
	1995-1999	90%	88%
	2000-2003	79%	83%
095	1990-1994	100%	100%
	1995-1999	76%	71%
	2000-2003	70%	66%

These data make clear the problem with using only five years' history to develop estimates of LGD for setting risk-based capital. As seen in Table 2, the choice of a different time period can easily reduce LGC estimates by 20% or more. The improved housing markets in the later time periods can be expected to increase the cure rates, as well, so the effect on relative LGD would be greater than on relative LGC. In our ongoing study, we will attempt to measure cure rates more precisely to quantify this impact. For now, assuming no change in cure rates, the relative LGD estimates would be identical to relative LGC. The effect of LGD on risk-based capital is virtually linear, so a 20% reduction in LGD results in a 20% reduction in risk-based capital. Thus, the use of 1995-1999 data for the estimation of LGD would result in capital levels at least 20% lower than using 1990-1994 data.



In Figure 2 (above) we show LGD estimates for first lien high LTV fixed rate loans by original LTV. These LGD estimates are calculated using the long-run average distribution of net salvage ratios (net salvage value divided by home value at origination) taken from MICA foreclosures between 1990 and 2003. The estimates also assume a 7.5% mortgage coupon, three months delinquency prior to start of foreclosure, nine months to complete foreclosure, five percent foreclosure costs, and six months to sell the foreclosed property. Using the same distribution of net salvage for all other loans as well, we show that as the original LTV goes higher, so does the increase in the LGD. We also note that these LGD values closely correspond to those LGD values for the same LTV groups as estimated in the recent Federal Reserve working paper on asset correlation and residential mortgages[6] discussed in more detail below. We strongly suggest that US regulators make use of this information and other sources of data that can provide a longer-term perspective of LGD.

[6] Ibid.

Implementing regulation for the A-IRB should place a heavy emphasis on the use of stress-scenario estimates of performance, rather than relying only on an institution's historical experience. If banks utilizing the A-IRB cannot provide historical PD and LGD performance during an economic downturn for each segment of their mortgage portfolio, then MICA recommends that the appropriate banking regulator, under Pillar 2, make adjustments to the PD and LGD factors based on the best available data.

To this end MICA is willing to perform an analysis for the benefit of the bank regulators regarding gross loss given default as well as other analysis for the agencies utilizing its historical performance data base for high LTV loans and share the results with the regulators. MICA urges the U.S. regulators to also make use of other national data bases such as Loan Performance Inc, and those of the GSEs to evaluate Pillar 1 and Pillar 2 regulatory-capital allocations.

D. Treatment for Loans Without Adequate Data

The recent GAO study noted above also rightly raises concern about risk weightings for loans without data. Banks can and should be required to use full stress-test and historical data to set RBC, but questions arise when such data are simply unavailable. This is, for example, the case with recent books of non-traditional and subprime mortgages which are new products yet to be tested over the full range of mortgage-market and macroeconomic cycles. It is critical that bank regulators set the supervisory LGD in such cases and also assign a highly-conservative PD, rather than using a "default" set of PD and LGD assumptions that equate to a neutral 100% risk weighting.

As demonstrated above, a 100% weighting is wholly inappropriate for high-risk mortgages, especially under stress. Indeed, the data presented above likely under-state the appropriate risk weighting because the mortgages assessed are far more traditional structures under more ordinary LTV conditions than those applicable to recent mortgage products. Assigning a mid-range weighting in such cases may create an incentive for banks to avoid the cost of extensive data collection and the risk that appropriately-stressed data would require higher weightings than those otherwise allowed by the regulators. This could lead to significant regulatory-capital arbitrage, in sharp contradiction to the incentives the agencies hope to create under Basel II.

E. Depth of MI Coverage Should be Reflected in RW Reduction

We recommend that a guiding principal for the banking agencies should be that they provide capital relief on insured high LTV loans that corresponds to the depth of CRM coverage obtained by the bank on these loans. In order to provide adequate benefit to reduce credit loss severity for unexpected losses, the banking agencies should assure that RW reduction would offset the intrinsically higher default frequency that the higher LTV loans experience. Thus, as the depth of insurance coverage increases and effectively lowers the risk inherent in the initial LTV of the loan, the capital relief obtained for this coverage should correspondingly increase. The standard coverage requirements specified

by the housing government sponsored enterprises for sellers of high LTV loans include provision for mitigating costs of holding and disposing of mortgaged collateral recovered because of default and these factors should be included in the calculation employed by the banking agencies to assess the capital relief obtained by MI coverage.

IV. Use of the Standardized Option

MICA recognizes that considerable comment has recently argued that the U.S. should adopt the standardized option included in the international Basel II Accord. Proponents of this approach believe that it would ensure competitive parity between large U.S. banks and foreign firms, as well as ease the "home/host" issues raised by disparities between the U.S. Basel II A-IRB and that approved elsewhere. If the regulators decide to permit a standardized option, this should be significantly revised from the version finalized in the international Accord. That option provides clear RBC treatment only for traditional mortgage structures and is, as Chairman Bernanke has noted[7], unsuitable for use in the U.S. Based on the need for such revisions and the importance of this capital requirement, MICA concurs that another round of public comment, hopefully on an accelerated schedule, is appropriate if the agencies propose the standardized option.

MICA does not oppose a regulatory-capital option simpler than the A-IRB for large banks, based in part on our view that, the longer Basel I remains in place, the greater the prospects for regulatory-capital arbitrage with complex products unanticipated in the 1988 rules. While complex standards that closely align regulatory with economic capital are the best option, regulatory standards that at least bring capital closer to economic capital would be far better than the prevailing capital standards and, thus, promote improved safety and soundness. Moreover, simpler options would have less implementation cost than the more complex ones, easing the transition to full Basel II implementation and, perhaps, eliminating the need for unnecessary modeling and related costs at banks with simple, high-quality credit-risk positions.

However, we urge considerable care in structuring any alternatives to the A-IRB and another round of full public comment should the agencies be inclined to authorize any such option. Unless carefully structured, a standardized option could exacerbate the prospects for regulatory-capital arbitrage, especially for banks with high-risk positions. Such banks may elect the standardized option not because it is appropriate for them, but rather because the simpler assumptions in it permit lower risk weightings than the A-IRB. Parallel runs between the standardized and advanced options -- which would protect the agencies from such arbitrage -- are not feasible because of the cost of the advanced runs, which would negate much of the desired benefit for the standardized option. Thus, the regulators will need to develop tough screens and robust risk weightings for high-risk positions before any standardized alternative to the A-IRB is permitted.

Further, MICA urges the agencies not to adopt the international standardized option with regard to mortgages. As you know, the standardized option provides for a

[7] "Bernanke in Letter, Defends 'Advanced' Basel II Approach," *Dow Jones Newswires*, September 5, 2006.

35% for prudential mortgages and unspecified higher rates for all others. The definition of prudential mortgages eligible for the favorable risk weighting is rightly based on LTV, but this may mask numerous other factors that can exacerbate credit risk. For example, the U.S. has an array of mortgage structures – hybrid adjustable-rate mortgages and no-documentation ones – that may pose significant risk despite the nominal LTV. Further, the international standardized option does not make clear that LTV must be assessed on a combined basis with any second liens issued simultaneously with the first lien [8]– again, a widespread U.S. practice generally not found abroad.

The risks of the weightings in the standardized option are still more acute for the higher-risk mortgages that come under the higher weightings. Here, LTVs on the first lien could be 100% or even higher and other facets of the mortgage structure – e.g., interest-only, negative-amortization, no documentation, etc. – may exist.

If the regulators decide on a standardized option, then we urge consideration of the clearly differentiated risk weightings proposed under Basel IA rather than the discretionary, unspecified imposition of higher risk weightings for higher risk mortgages. Without a clear standard set by rule, significant differences between agencies could occur with undesirable competitiveness implications. MICA believes the proposed risk weightings under Basel IA provide a clear framework for the standardized option that should be adopted if the standardized option is made available.

Conclusion

Again, we thank you for your consideration of our views and stand ready to provide whatever additional information is of use.

Sincerely,

Suzanne C. Hutchinson

[8] For further explanation as to appropriate risk weights for second liens please refer to our extensive discussion of this subject in section V of our comments on the Basel IA NPR as submitted to the U.S. bank regulatory agencies on March 26, 2007.