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January 16, 2024

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street, S.W., suite 3E-218
Washington, D.C. 20219
Docket ID OCC–2023–0008
RIN 1557-AE78
via: regulations.gov

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551
Docket No. R–1813
RIN 7100-AG64
via: regs.comments@federalreserve.gov

James P. Sheesley
Assistant Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AF29
via: comments@FDIC.gov

**Re: Arch's Response to Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity**

Dear Sir or Madam:

Arch Capital Group Ltd., on behalf of itself and its subsidiaries ("Arch"), appreciates the opportunity to submit this comment letter in response to the Federal Reserve System, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (together, the "Agencies") proposed revisions to the capital requirements applicable to large banking

organizations and to banking organizations with significant trading activity, the U.S. implementation (such amendments, the "Proposed Basel III Regulations" or the "Proposal").[1]

Arch, through its insurance subsidiaries, provides commercial, institutional, and individual customers with mortgage, property-casualty, and reinsurance offerings on a worldwide basis. Arch has made a long-term strategic commitment to the U.S. mortgage market, investing in, managing, and distributing credit risk in a variety of single family and multifamily executions. Arch has developed its own internal credit risk and econometric models and invests heavily in the intellectual capital required to support underwriting decisions and risk management. Thus, Arch is well-positioned to provide input on the Proposed Basel III Regulations related to residential mortgage exposures.

More specifically, Arch, through its subsidiaries, Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, (together "Arch MI") is a leading mortgage insurance provider in the United States, having $293 billion of insurance in force as of September 30, 2023. Arch's reinsurance subsidiaries are leading participants in mortgage credit risk transfer ("CRT") programs, both in the U.S. and in Europe. Arch has continuously participated in Fannie Mae and Freddie Mac's (together, the "GSEs") CRT programs since their inception in 2013 as an investor and advisor in various structures and transactions. Since 2018, Arch has also provided credit protection to large banking institutions in Europe, a market that has grown significantly in the past couple of years. It is with this varied experience in pricing, managing, and distributing mortgage credit risk in a variety of contexts, that Arch is pleased to offer the following comments to the Proposal for consideration.

## I. Executive Summary.

Arch appreciates the intent of the Agencies to implement a consistent risk-based capital requirement for residential mortgage exposures across large banking institutions, and the challenge of simultaneously preserving market stability and credit availability for consumers. Unfortunately, the Agencies' Proposal fails to balance these objectives. The Agencies' Proposal includes a significant increase in bank capital requirements for high loan-to-value ("LTV") mortgages, which threatens irreparable harm to low-wealth borrowers and people of color. In fact, the Proposal will likely eliminate high-LTV lending at large banks altogether by way of negating mortgage insurance's ability to reduce the effective LTV (and resulting loan risk weight) of residential loans.

The Proposal fails to take into account the significant reforms made to mortgage underwriting rules and standards since the Global Financial Crisis ("GFC") as well as the

[1] 88 Fed. Reg. 64028 (September 18, 2023).

significant improvement in the mortgage insurance ("MI") industry's financial strength and claims-paying ability. Nor does the Proposal recognize the significant risk management and loss-mitigating benefit credit enhancement provides on losses associated with default. As drafted, the Proposal will likely accelerate the shift of mortgage originations from prudentially regulated banks to more lightly regulated independent mortgage banks, which may reduce the number of Community Reinvestment Act ("CRA") home loans offered to low- and moderate-income ("LMI") communities, a critical tool in tackling the affordability challenges facing families today.

To mitigate the impact on lower-wealth borrowers while preserving market stability, Arch proposes the Agencies adopt amendments to restore a bank's ability to recognize credit for private mortgage insurance on loans held on its balance sheet and provide capital relief for banks that transfer credit risk through other means, such as capital markets and reinsurance transactions.[2] While the Agencies could consider just lowering the risk weights assessed against mortgages to preserve housing finance options for low- and moderate-income families, this solution is suboptimal as it reduces the amount of capital available to pay losses in the event a bank undergoes stress. Providing an incentive for credit risk transfer, on the other hand, will enhance the safety and soundness of the U.S. banking system by increasing and diversifying the capital available to banks to absorb losses, while also preserving housing finance options for low- and moderate-income families. This approach also better aligns with aspects of the empirically derived capital framework implemented by the Federal Housing Finance Agency ("FHFA") for the GSEs, as reviewed by the Financial Stability Oversight Council ("FSOC").

## II. The Proposal Would Disproportionately Harm Lower-Income Borrowers, Including Many First-time and Minority Borrowers.

As the Agencies are undoubtedly aware, homeownership is already tilted strongly toward upper-income and White households. The Black homeownership rate of 45.5% as of the end of the third quarter 2023 is nearly 30 percentage points below the White rate of 74.5%. The Hispanic homeownership rate is marginally better than the Black rate – 49.4% – but still far behind White households.[3] Increasing capital costs as LTVs rise will disproportionately impact low-income and minority borrowers because they are more likely to need high-LTV (above 80%) loans to purchase a home. As FDIC Board Member Jonathan McKernan commented upon release of the Proposal:

> "There likely will be real economic costs.... The increased capital requirements could lead to an increase in interest rates for low- and moderate-income and other

[2] In addition to the recommendations made herein, Arch also endorses the amendments proposed by the Reinsurance Association of America in its Basel III comment letter to more fulsomely allow insurers to qualify as eligible guarantors with corresponding adjustments to the risk weights assigned to eligible guarantees.

[3] https://fred.stlouisfed.org/series/BOAAAHORUSQ156N

historically underserved borrowers who cannot always afford a 20% down payment, making it that much harder for these families to achieve homeownership."[4]

In a recent study by the Urban Institute based on 2021 Home Mortgage Disclosure Act data, 604 banks originated mortgages of which 23 have assets above $100 billion. These 23 banks accounted for 52% of total bank originations in 2020 and 2021, which in turn corresponds to an estimated 1.8 million originations that could be impacted by this Proposal.[5] Parsing this data further, Exhibit 1 demonstrates the disproportionate importance of high-LTV loans to LMI communities. High-LTV loans comprise 19% of all loans made to LMI communities, while accounting for only 10% of loans made to high-income communities.[6]

**Exhibit 1**

**High-LTV Bank Loans versus All Bank Loans, by Neighborhood Income**

| Neighborhood Income-Level | Loan Count of High-LTV Loans | Loan Count of All Bank Loans | Percentage of High-LTV Loans |
|---|---|---|---|
| LMI | 45,000 | 239,000 | 19% |
| Middle Income | 95,000 | 606,000 | 16% |
| High Income | 97,000 | 992,000 | 10% |
| All | 238,000 | 1,837,000 | 13% |

Exhibit 2 shows that high-LTV loans are far more prevalent among Black borrowers seeking to purchase a home than for White borrowers. For instance, high-LTV loans accounted for approximately 23% of loans to Black borrowers, whereas the percentage of high-LTV loans accounted for only 13% of home loans to White borrowers.[7] Even more notable than the higher prevalence of high-LTV loans to Black borrowers is the lack of loans made to Black borrowers. Only 5% of loans made by banks are made to Black borrowers.

[4] https://www.fdic.gov/news/speeches/2023/spjul2723c.html
[5] Goodman, Laurie and Zhu, Jun. "Bank Capital Notice of Proposed Rulemaking," Urban Institute, Sept. 2023, pg 7.
[6] Id., pg. 8.
[7] Id.

**Exhibit 2**

**High-LTV Bank Loans versus All Bank Loans, by Borrower Race or Ethnicity**

| Race | Loan Count of High-LTV Loans | Loan Count of All Bank Loans | Percentage of High-LTV Loans |
|---|---|---|---|
| White | 162,000 | 1,286,000 | 13% |
| Black | 21,000 | 92,000 | 23% |
| Hispanic | 31,000 | 165,000 | 19% |
| Asian | 21,000 | 294,000 | 7% |
| Other | 1,000 | 5,000 | 20% |
| All | 238,000 | 1,837,000 | 13% |

Bank originations are critical to growing affordable homeownership, and mortgage insurance is key to ensuring that LMI neighborhoods and Black borrowers are not further disadvantaged. In 2022, private MI companies helped more than one million borrowers purchase or refinance their homes – more than 60% of whom were first-time homebuyers.[8] If the Proposal is enacted without amendment, the cost of credit will not only rise for high-LTV borrowers, but worse yet, some banks are likely to leave the high-LTV marketplace altogether, further disadvantaging the borrowers in greatest need.

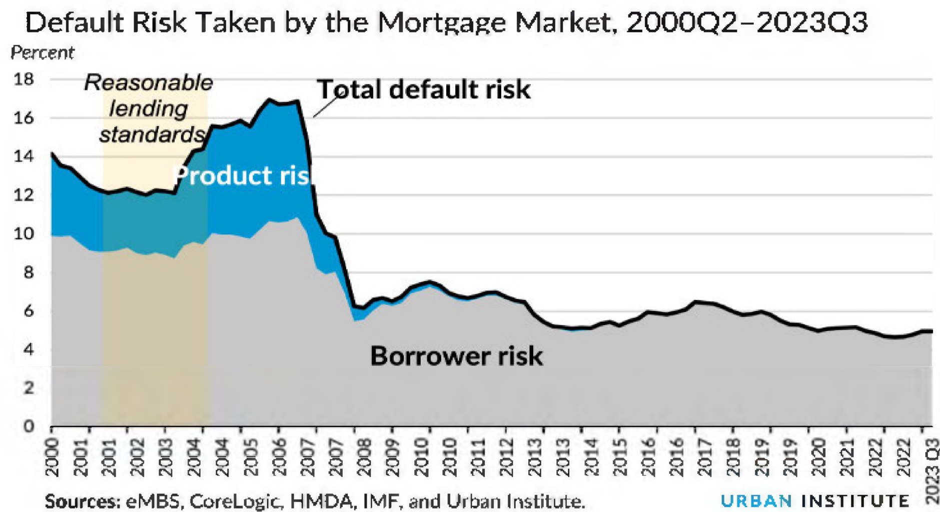
**III. The Proposal Fails to Recognize that Mortgage Underwriting is Significantly More Stringent Since the GFC.**

The credit risk of insured loans, the risk management practices, and the capital strength and claims-paying ability of the MI industry are all dramatically better than prior to the GFC. Benefitting from regulatory reforms such as the Ability-to-Repay and Qualified Mortgage regulations in 2014 ("ATR" and "QM", respectively), the mortgages originated today are far safer than before the GFC. Simply put, the market is devoid of the risky product features that most contributed to the prior housing bubble, and GFC. Institutions can no longer originate negative amortizing loans, option ARMs, interest-only loans, and no-documentation loans. Exhibit 3 reproduces the Urban Institute's Housing Credit Access Index ("HCAI") through 2023 Q3. HCAI measures the difficulty of getting a mortgage in the United States by precisely quantifying lenders' tolerance for risk. The chart demonstrates the dramatic decrease in credit risk in the market since the GFC. It plummeted in 2008 and has remained rather steady for the past 15 years.

[8] Statement of Seth D. Appleton President of U.S. Mortgage Insurers before the United States House of Representatives Committee on Financial Services Subcommittee on Housing and Insurance, December 6, 2023 hearing on 'Housing Affordability: Governmental Barriers and Market-Based Solutions', p. 3.

**Exhibit 3**

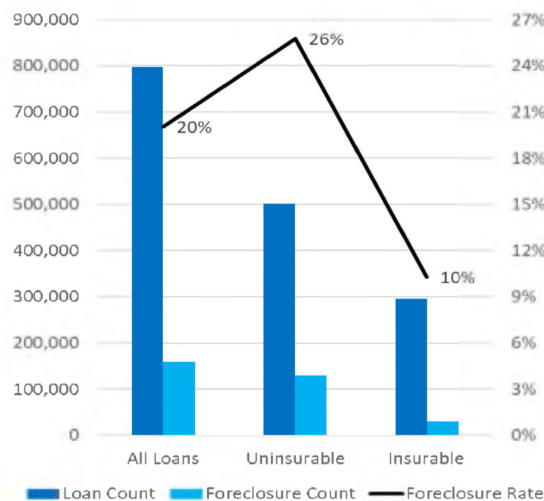
## Mortgage Credit Availability Index




Excluding uninsurable loans[9] from the market reduces the potential for future insured losses by an order of magnitude. Exhibit 4 is a stylized example illustrating how there would have been far fewer foreclosures if today's lending standards, including the ATR and QM reforms, were in place in 2006.

**Exhibit 4**

## 2006 Foreclosure Rate Comparison




[9] Uninsurable loans are defined as having one or more of the following attributes: negative amortizing loans; option ARMs; interest-only loans; limited or no-documentation loans; credit scores <620; debt-to-income ratios > 50; and LTV > 97.

Merely excluding loans that are no longer permitted reduces the foreclosure rate by half. Adjusting the 2006 origination data further to account for the improvements in credit score and LTV mix since 2006, reduces the foreclosure rate on the 2006 vintage even further from 10% to 8%. Regulatory reforms, such as the ATR and QM regulations, have created guardrails that should prevent significant deterioration in credit quality even if lenders' risk appetites change. Indeed, a 2019 assessment by the Consumer Financial Protection Bureau ("CFPB") found that approximately 50-60% of mortgages originated between 2005 and 2007 that experienced foreclosure in the first two years after origination were mortgage loans with features the ATR/QM rule generally eliminates or restricts.[10] As a result of these reforms, mortgage underwriting standards are significantly less risky, making it highly unlikely that the industry will face catastrophic losses as severe as the losses experienced during the GFC .

**IV. The Proposal Fails to Recognize the Significant Financial Strength of the MI Industry and the Regulatory Reforms Since the GFC**.

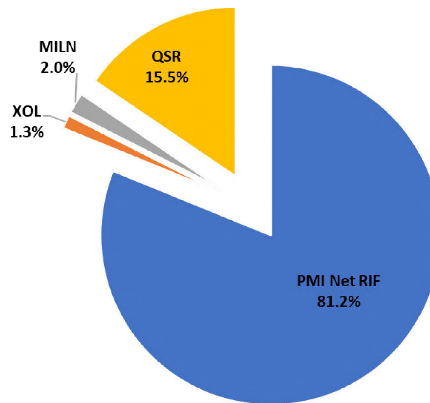
Private mortgage insurers paid over $60 billion in claims between 2008 and 2022 or 97% of valid claims.[11] Moreover, the risk-management practices of the MI industry have improved significantly in the last decade as Arch, and other mortgage insurers, have shifted from buying and holding all credit risk on balance sheet to a buy-manage-and-syndicate risk model, similar to the risk management practices implemented by the GSEs post-GFC. Bottom line, the industry is much better positioned than it was in 2008 to weather a severe stress event. Since 2015, mortgage insurers regularly transfer a portion of credit risk to reinsurers through quota share reinsurance ("QSR") and excess of loss reinsurance ("XOL"), and to sophisticated capital market investors through mortgage insurance linked note ("MILN") transactions (QSR, XOL reinsurance and MILN together, "MI CRT"). As of September 30, 2023, the six active GSE-approved mortgage insurers had $403.92 billion of risk in force ("RIF"), of which they ceded $76.04 billion or 18.8% of risk to external third parties.

[10] CFPB's Ability-to-Repay and Qualified Mortgage Rule Assessment Report, January 2019 (pg. 87). https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf

[11] Sources: SEC filings and annual statutory filings of private mortgage insurers; receivership reports (with respect to PMI Mortgage Insurance Co).

**Exhibit 5**

## Composition of MI CRT




Arch MI utilizes MI CRT to optimize its capital requirements and manage its net loss exposure in its realistic disaster scenario, a stress scenario that assumes home prices decline 25% below their fundamental value. By ceding credit risk to third parties and prudently managing its net exposure, Arch MI would easily survive a severe stress. In addition to enabling mortgage insurers to manage their risk aggregations, regularly issuing MI CRT transactions with sophisticated third-party investors and reinsurers provides Arch MI with important market feedback and third-party views of the credit risk of its insured loans. The feedback loop provides both the mortgage insurers and their regulators with an independent view of the credit risk being insured. Banks stand to enjoy these same benefits by regularly transferring credit risk to mortgage insurers and other CRT investors.

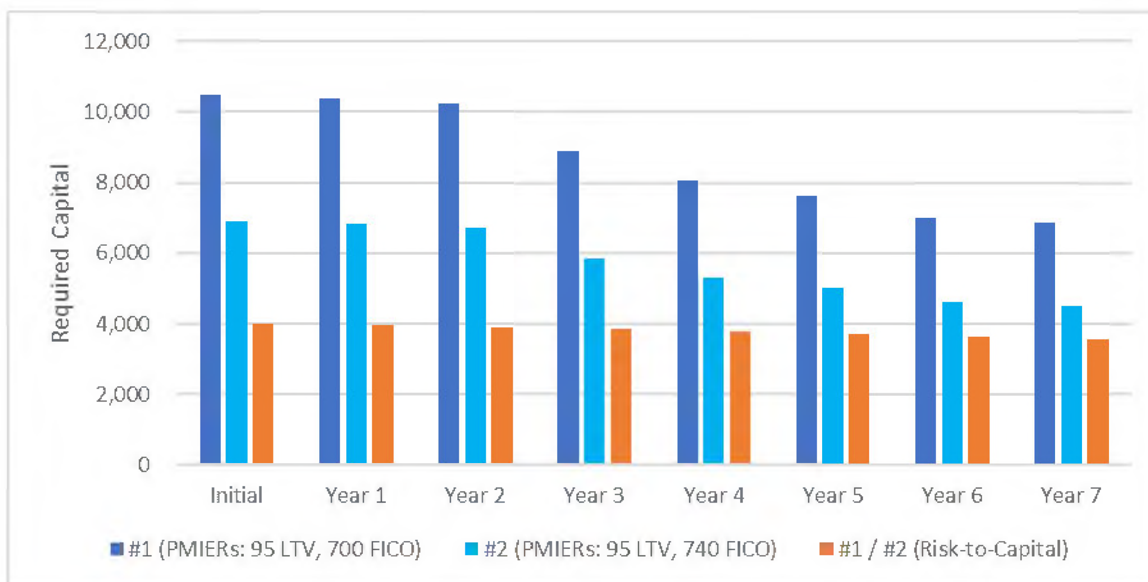
Finally, the terms of the insurance coverage offered and the capital positions of mortgage insurers have never been stronger. The GSEs implemented private mortgage insurer eligibility requirements ("PMIERs") in 2015 to better manage their exposure to mortgage insurers. Two of the most critical elements of PMIERs are 1) strict insurance policy requirements that ensure all valid claims are timely paid, and 2) a risk-based capital requirement, which institutionalized conservative capital standards that are significantly higher than what exists under state insurance regulation. For completeness, PMIERs also require mortgage insurers to maintain appropriate operational and risk- management processes, including quality-control testing, and the GSEs audit compliance with PMIERs annually.

To illustrate the conservative risk-based capital requirement of PMIERs, Exhibit 6 compares the PMIERs and state insurance regulatory capital requirements applicable to two loans.

The illustrative loans share the same LTV and only differ in credit score. The first loan requires initial PMIERs capital of more than two and a half times when compared to state regulation, while the second loan requires 73% higher capital under PMIERs. The increased risk-based capital under PMIERs continues throughout the life of the loan, despite favorable seasoning factors applied to the loans starting in year three.

**Exhibit 6**

**Comparison of PMIERs versus State Insurance Regulation (Risk-to-Capital)[12]**

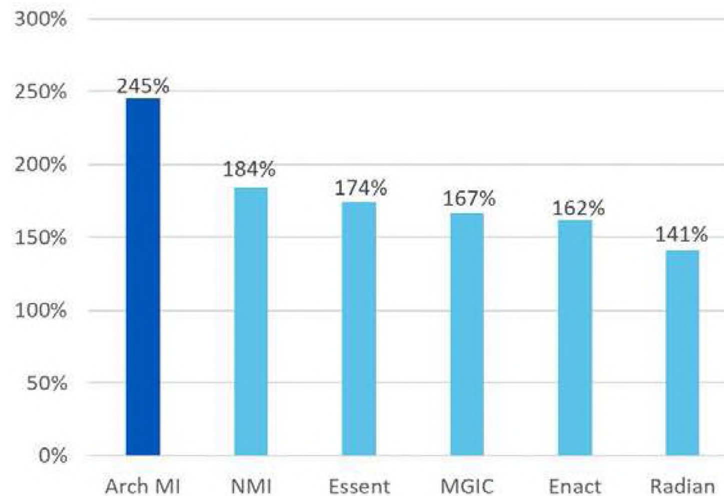



Not only is the PMIERs capital requirement a significantly higher measure of capital, but mortgage insurers are currently holding between 1.5 to 2.5 times that amount. Exhibit 7 reflects the PMIERs Sufficiency Ratios of the mortgage insurers approved to insure loans sold to the GSEs.

[12] Illustrative example based on initial $100,000 risk in force. The risk-to-capital ratio is the predominant metric used by state insurance regulatory entities.

**Exhibit 7**

**PMIERs Sufficiency Ratio as of Sept. 30, 2023**[13]




The Sufficiency Ratio divides a mortgage insurer's Available Assets by its Risk Based Required Assets (which is a risk-based loan level measure). As illustrated, the entire industry is well capitalized. Given the counterparty strength of the MI industry, removing credit for MI when calculating the risk weight on a residential mortgage exposure held on a bank's balance sheet makes no sense. Doing so incorrectly increases bank capital requirements on insured high-LTV loans, which needlessly increases the cost of originating mortgages and thereby reduces access to credit for borrowers least able to make a 20% down payment. Moreover, it would create an incentive for banks to hold all the credit risk they do originate on balance sheet – a risky proposition if history is a guide.

**V. Removing the Benefits Banks Garner from MI Coverage Needlessly Harms Both Banks and Borrowers.**

Arch supports the Agencies' Proposal to modify the risk weights on residential home loans to a more granular risk-based approach, and broadly agrees with assigning risk weights based on a loan's purpose and its LTV. But retaining the ability for banks to offset those higher risk weights via mortgage-insurance coverage is essential if banks are to adequately meet the needs of disadvantaged communities and borrowers.

[13] Sources: SEC filings and annual statutory filings for Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, Essent Guaranty, Inc., Radian Guaranty, Inc., National Mortgage Insurance Corp., Mortgage Guaranty Insurance Corp. and Enact Mortgage Insurance Corp.

Notably, the Agencies considered eliminating the benefit of mortgage insurance on the risk weights applicable to residential home loans in their 2013 rulemaking.[14] This was prior to the significant regulatory reforms and improved business practices that increased the counterparty strength of mortgage insurers, but they wisely decided to retain credit for MI when calculating the risk weights for residential mortgage exposures even at that time.

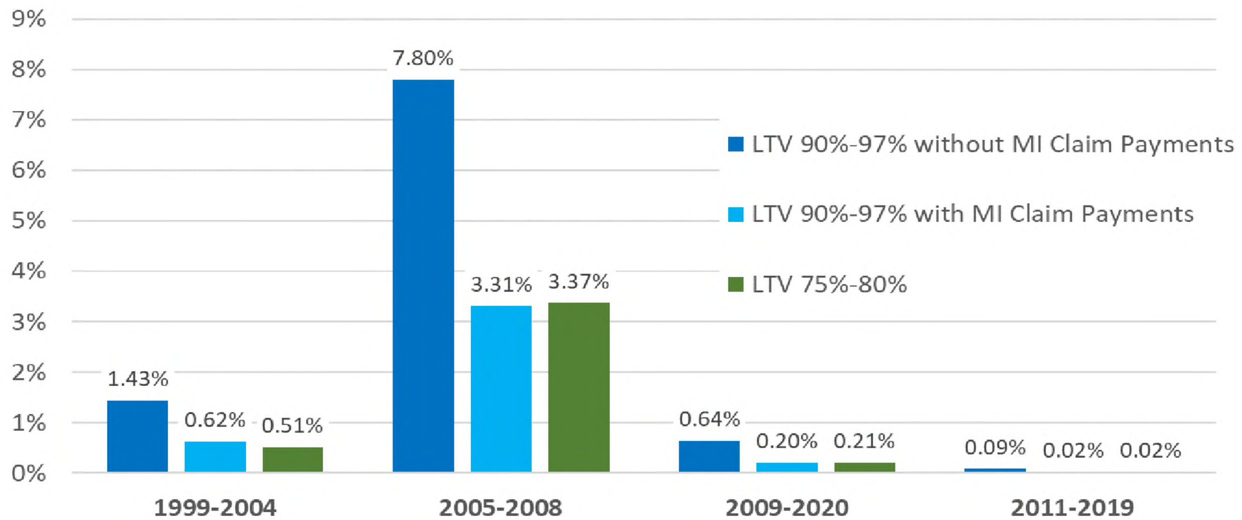
The latest bid to reverse that position while citing "the performance of private mortgage insurance during times of stress," is misguided. It does not reflect the claims-paying record nor the improvement in the MI industry's financial condition since the GFC. Removing credit for MI now, when the industry is stronger than ever, is illogical and will unnecessarily increase the cost of home loans and reduce access to credit. Furthermore, denying the value of credit enhancement – MI or CRT - is out of step with the capital requirements applicable to GSE loans. The same high-LTV loan purchased by a GSE is subject to very different capital treatment since the Enterprise Regulatory Capital Framework gives the GSE explicit capital credit for MI and for (re)insurance CRT – neither of which is available to a bank.

## VI. The Agencies Should Provide an Incentive for Banks to Transfer Credit Risk to Advance Market Stability While Preserving Access to Affordable & Sustainable Mortgage Credit.

MI covers losses up to a defined coverage percentage, and effectively reduces the losses experienced by a mortgagee up to the coverage amount. For example, Exhibit 8 illustrates that the GSEs' losses on mortgages with LTVs between 90% and 97% are approximately the same as the losses experienced on loans with LTVs between 75% to 80%, even during stressful periods.

[14] https://www.federalregister.gov/documents/2013/10/11/2013-21653/regulatory-capital-rules-regulatory-capital-implementation-of-basel-iii-capital-adequacy-transition

**Exhibit 8**[15]




In recognition of the substantial value MI plays in reducing losses at the GSEs, their regulator, the FHFA, did the opposite of what is being proposed by the Agencies. The FHFA lowered GSE capital requirements and borrower fees on loans covered by mortgage insurance. Exhibit 9 further demonstrates the loss-mitigating impact of mortgage insurance on loss severities.[16] Across all origination years, the loss severities of GSE loans that defaulted and were liquidated were higher on loans without MI. In other words, MI reduced the GSEs' loss severities on loans across all origination years compared to loans without MI.

[15] Source: Fannie Mae's Data Dynamics, which excludes loans that do not qualify under Fannie Mae's current guidelines. Note: Loss rate for LTV 90% to 97% without MI Claim Payments – Net Loss Rate/Loss Severity * Loss Severity without MI Claim Payments.

[16] Urban Institute's Mortgage Insurance Data at a Glance, 2023. https://www.urban.org/sites/default/files/202308/Mortgage%20Insurance%20Data%20At%20A%20Glance%202023.pdf

**Exhibit 9**

**Loss Severities**

| Origination year | Loss severity for loans without PMI | Total severity for PMI loans | Severity without MI recovery | MI recovery |
|---|---|---|---|---|
| 1994–2004 | 33.3% | 23.7% | 42.1% | 18.5% |
| 2005–2008 | 41.7% | 30.8% | 50.0% | 19.2% |
| 2009–2010 | 28.2% | 17.6% | 34.6% | 17.0% |
| 2011–2016 | 19.1% | 9.9% | 24.3% | 14.5% |
| 2017–2019 | 4.5% | 2.4% | 9.1% | 6.6% |
| 2020–2022 | 1.6% | 1.0% | 3.1% | 2.1% |
| Total | 37.6% | 26.4% | 44.7% | 18.3% |

Banks should similarly be incentivized to manage their losses by ceding credit risk to third-party insurers and investors. Importantly, to ensure bank participation in the higher-LTV lending space, capital regulations should allow MI to reduce the LTV used to calculate the risk weight assigned to residential mortgage exposures. Arch is not suggesting changes to the base risk-weight suggested by U.S. bank regulators in the grids applicable to regulatory residential real estate exposures from the Proposal.[17] Rather, Arch respectfully proposes that the Agencies require banks to calculate the effective LTV to determine the risk weight, as reflected in the Exhibit 10 below.

[17] 88 Fed. Reg. 64028 (September 18, 2023) at pg. 163.

**Exhibit 10**

**Risk weights for residential real estate exposures that are not dependent on the cash flows of the real estate**

| Base Risk Weight | ≤ 50% Effective LTV ratio | 50% < Effective LTV ratio ≤ 60% | 60% < Effective LTV ratio ≤ 80% | 80% < Effective LTV ratio ≤ 90% | 90% < Effective LTV ratio ≤ 100% | > 100% Effective LTV ratio |
|---|---|---|---|---|---|---|
| | 40% | 45% | 50% | 60% | 70% | 90% |

The effective LTV ratio reflected in the table above is equal to the LTV net of MI coverage. For example, if a bank originates a 90% LTV loan with 25% MI coverage, the effective LTV is 67.5%, or 90% x (100% – 25%). The proposed risk weights are unchanged. The difference is that the LTV used to determine the risk weight should be the effective LTV net of MI coverage. One note of clarification, Arch supports retaining the minimum risk weight at 40%, as proposed. In other words, a bank should not be able to procure 100% coverage to reduce the risk weight to zero.

Allowing a bank to reduce the LTV of a loan by the MI coverage percentage will incentivize banks to transfer a portion of credit risk to the private market. Incentivizing CRT optimizes the amount of capital in the housing finance system to pay losses, which will in turn enhance financial stability while preserving housing finance options for low- and moderate-income families.

**VII. Conclusion**

Arch understands and supports the Agencies' intention to adopt a more risk-based capital framework, including risk weights on residential mortgage exposures that increase as LTVs increase. However, Arch strongly disagrees with the Agencies' irrational decision to deny banks the value of private credit enhancement tools like MI, which exacerbates the adverse impact to lower-income, lower-wealth borrowers at a time when closing wealth gaps and homeownership gaps is a stated national priority.

The good news is that the Agencies can effectively protect the safety and soundness of banks while expanding mortgage credit options for LMI and lower-wealth homeowners by recognizing the value of credit enhancement with strong counterparties, including MIs, in any final

rule. By enhancing a bank's ability to provide sustainable mortgage credit to credit-worthy borrowers with effective risk-mitigating tool like MI and CRT, the Agencies will simultaneously enhance the safety and soundness of the largest commercial banks while also improving the economic fortunes of low-income and low-wealth borrowers in often underserved urban and rural communities. Thank you for your thoughtful consideration of these recommendations.

Sincerely,

David Gansberg