



**Mortgage
Insurance
Companies
of America**

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Executive Vice President

October 27, 2008

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Docket Number OCC 2008-0006

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1318

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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: OTS-2008-0002

Ladies and Gentlemen:

The Mortgage Insurance Companies of America (MICA) is pleased hereby to comment on the agencies' notice of proposed rulemaking (NPR, found at *Federal Register* Vol.73, No. 146 pp.43982- 44060) on the revisions to risk-based capital generally known as the Standardized approach for Basel II. Aspects of this comment parallel views we provided on the Basel II NPR and Basel IA NPR filed in 2007¹, with some comments and data duplicated here because of their relevance also to this proposal. We have gone into depth on several of the questions about the proper risk-based capital (RBC) for mortgages and the role of private mortgage insurance based on our view that it is critically important for these aspects of the rules

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¹ MICA comments filed with all bank regulators on March 26, 2007.

to align regulatory with economic capital to the greatest degree possible. The consequences of failing to so align capital have become all too clear in the current market crisis. Reform in this area is critical to long-term stabilization of the U. S. financial system and to ensuring that the market does not repeat the mistakes that led to this unprecedented environment.

During the past year, the U.S. mortgage market has suffered serious strains as house prices in many areas of the country have fallen dramatically. Unlike past housing cycles, the precipitous decline in prices, for the most part, has not been driven by national or regional economic factors. Certainly, pockets of regional economic stress existed, but the serious decline in house prices in the stressed areas of the country resulted from the risk associated with the mortgage instruments themselves. The prevailing practice was to offer mortgage instruments which, because of the terms of the instrument and the quality of underwriting, increased a borrower's exposure to rising interest rates, falling house prices and mortgage liquidity risk, without due regard to a borrower's ability to make scheduled payments or a realistic understanding of the cyclical nature of the housing market.

Additionally, risk models structured by ratings agencies, mortgage investors and mortgage securitizers to estimate likely losses during periods of stress have been shown to be seriously flawed and the entities that relied on these models have suffered unexpected losses in their retained mortgage risk. These models failed to assess the inherent risk of the mortgage instruments and too often over-relied on a single risk factor such as the borrower's credit score to substitute for careful analysis of the layered risks inherent in all mortgage lending, especially in products such as simultaneous seconds, low and no documentation mortgages and negative amortization loans such as pay option ARMs. Finally, the failure of these models initiated a liquidity squeeze in the mortgage market as investors in mortgage-related securities who relied on the nationally-recognized statistical ratings organizations (NRSRO) ratings faced unexpected losses as new investors were loathe to enter the market

It is important that the Standardized approach as used in the United States not make the same mistakes relating to mortgage risk that have caused so much trouble in the mortgage markets to date. MICA believes that the NPR is a substantial improvement over current rules and we thus urge quick action on the Standardized option. However, we recommend below several changes that we believe will strengthen this approach.

Our key points include:

- MICA agrees with the agencies decision to set mortgage risk-based capital based on loan-to-value (LTV) ratios, as proposed. While other factors such as borrower credit score and the pricing information reported by banking organizations under the Home Mortgage Disclosure Act (HMDA) are useful to the mortgage lender and insurer, we do not believe that these factors are reliable alternatives to the use of initial LTV as the determinative risk weight factor. If the agencies give consideration to the inclusion of any of these other factors in determining risk weights, a careful analysis should be conducted of the correlation between these factors and the probability of default (PD) and loss given default (LGD) of loans during periods of falling house prices. Specifically with respect to credit scores, we note again the data we provided earlier in our Basel II and Basel IA comments demonstrating that credit scores are subject to significant erosion of their ability to predict foreclosure likelihood for high LTV loans under stressed conditions such as those now evident in the mortgage market.
- We concur with the focus on combined LTV when evaluating mortgage exposures. MICA has provided data in prior comments noting the high risk of default of simultaneous second liens in so-called “piggyback” mortgages. Market conditions are now demonstrating the validity of this data and, thus, the risk associated with these structures. In this regard, we support the use of the original LTV method proposed by the agencies as this applies to funded and unfunded second liens either held by the same institution holding the first lien or held by another entity. However, as noted below, we remain concerned that the risk weighting on second liens as proposed does not reflect the high level of risk associated with these loans.
- We support the proposed recognition of mortgage insurance in this proposal and suggest a regulatory definition to be used in defining a qualified private mortgage insurer that responds to the President’s Working Group on Financial Market’s Policy statements that regulatory capital rules should not rely on NRSRO ratings. The use of mortgage insurance in the Basel process reflects MI’s proven role as a regulated, reliable form of credit risk mitigation (CRM) with strong claims-paying ability and, most importantly, with capital at risk that is not vulnerable to liquidity risk. We

also strongly support the proposal of the agencies that the capital relief on insured high LTV loans should correspond to the depth of MI coverage obtained on these loans. This is appropriate since, as the depth of coverage increases, the coverage effectively lowers the risk inherent in the initial LTV of the loan.

- We remain concerned that the proposed risk weightings for high-LTV second liens with combined LTVs (CLTVs) above 90% do not reflect the full risk of such loans. We are concerned that the risk weights are not high enough to prevent capital arbitrage by a lender originating two loans in lieu of a single first lien with MI. We recommend that the risk weights for second liens be significantly increased.
- While the risk weights associated with prudentially underwritten first lien mortgages adequately reflect the risk of these loans, we believe the rule should clarify that loans with specified high-risk factors should have dollar-for-dollar capital requirements. We specify the high-risk factors which we believe warrant this significantly higher level of required capital.

I. LTV as the Primary Driver of Risk Weight for First Liens

MICA reaffirms our endorsement of the focus on LTV in the proposed Standardized approach. We concur that LTV and CLTV should always be known to a lender, thus making it a useful risk predictor that does not impose additional burden. Most importantly, LTV is a meaningful and proven predictor of potential loss and borrower default.

A. Calculation of LTV

In Question 13, the agencies seek comment on the pros and cons associated with two alternatives for calculating LTV. The two alternatives differ on the way in which unfunded and funded portions of a loan would be risk-weighted. Under both, the denominator of the calculation would equal the lesser of the property acquisition cost or the estimate of value at the origination of the exposure. Under the first option, the funded portion of a residential mortgage exposure would have a risk weight reflecting its carrying value. For the unfunded portion, the bank would risk weight the notional amount of the exposure (i.e., the maximum contractual commitment) multiplied by the appropriate credit conversion factor. For a loan that has both funded and unfunded components, a bank would calculate separate risk-

weights based on separately calculated LTV ratios. In the case of a loan with a funded second lien, the loan amount of this funded portion would be the principal amount of the exposure plus the maximum contractual amounts of all senior exposures secured by the same residential property. If the second lien is unfunded, the bank would calculate a separate loan amount and LTV ratio for the unfunded portion, which would include the prior funded portions.

For the second alternative, the agencies suggest that a banking organization would not calculate a separate risk-weighted asset amount for the funded and unfunded portion of the residential mortgage exposure. Instead, there would only be a single LTV ratio representing the combined funded and unfunded amount when calculating the LTV ratio for a given exposure.

When assessing the best approach to calculating LTV, it is important that all contractual obligations on the same property—whether funded or unfunded at the time of origination—be included in the calculation. The borrower's real equity in the property at the time of origination is the key component in determining probability of default under stress. We note that the real equity of the borrower is net of the estimated cost of selling the property. An unfunded loan reduces the real equity at the time of origination since the borrower may draw the unfunded line of credit to effectively recoup any cash investment made at origination. Indeed, unless the borrower is barred from drawing down the unfunded loan if a reappraisal of the property does not show appreciation which would set the new LTV (less the draw down) equal to or below the original LTV, the bank should treat the unfunded portion of the loan as equivalent to a funded loan from the point of view of the bank's own risk position.

MICA thus believes that the funded portion must not be separated from the unfunded portion in calculating the LTV of any mortgage exposure. While it is true that the loss given default will be affected by the amount that is funded at the time of default, the probability of default on the loan will reflect both the funded and unfunded portions at the time the loan is originated.

B. Use of Credit Scores

In Question 14, the agencies request comment on any risk-sensitive measures other than LTV that could be used to segment residential mortgage exposures by risk level with specific reference to borrower credit score. There are significant differences between LTV and credit scores (or other borrower attributes). 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 lower values of PD, they are not a direct substitute for lower LTVs or deeper MI coverage in offsetting unexpected losses and should not be treated as equivalent forms of protection.

In our comments on the Basel 1A proposal, we presented new data on the utility of credit scores to predict the likelihood of foreclosure of high LTV loans in stress scenarios. This data demonstrates that credit scores should not be used to set risk-based capital. We also believe that this data argues against the weighting of borrower credit. Our presentation is attached in Appendix A.

When market stress occurs, even if not exacerbated by interest-rate risk, MICA data demonstrate that credit scores are highly unreliable predictors of PD, with PD actually performing in highly unexpected ways. Risk based capital is what lenders must hold to protect against unexpected risk. The MICA data starkly illustrate the conclusion that, while credit scores are highly correlated with expected risk, they have very little correlation with unexpected risk. As banking regulators are now realizing, unexpected losses in mortgage lending are driven, more than anything else, by declines in equity in the home until the real equity is negative. Declining home values are a great equalizer in a mortgage portfolio, affecting all borrowers regardless of their prior credit history (i.e. even if the borrower can't make the payments, if they can sell the house and realize equity after repaying the loan, they will and the lender will have no loss.) 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 has limited usefulness in setting capital requirements. As a result, we recommend that the regulators not permit reliance on borrower credit scores alone to determine risk weights for mortgages. We expand on this issue below in our discussion on imprudent mortgages.

II. Recognition of Mortgage Insurance

MICA supports the recognition of private loan-level mortgage insurance in the Standardized approach as it creates an appropriate incentive for use of proven credit risk mitigation that meets the regulators' goal of aligning regulatory with economic capital. As detailed in our prior comments, MI is markedly different from many other types of credit risk mitigation (CRM). It is, for example, regulated and capitalized to absorb mortgage risk, in sharp contrast to simultaneous seconds and credit-derivative structures that are proving to be incapable of absorbing default-risk during the current period of

severe stress. The current crisis in the credit default swap market makes clear that these structures are not reliable alternatives to mortgage insurance, which has a history of functioning as a reliable means of risk transfer and loss mitigation across economic cycles. Likewise, the idea that a second mortgage covering a first mortgage with an LTV of 70% or more serves as effective loss mitigation for the first mortgage has been shown to not work .

MICA endorses the work done on credit derivatives by the Joint Forum of international bank, securities and insurance regulators.² At a minimum, we urge that the U. S. capital rules defer any reliance on credit derivatives unless or until all of the Joint Forum recommendations are put in place and then validated under market stress conditions. This is particularly true with the recommendations related to the credit-derivative market's infrastructure, which now appears wholly non-functional.

A. Eligible Mortgage Insurance Providers

The Standardized approach proposes that “a banking organization could reduce the loan amount of a residential mortgage exposure up to the amount covered by loan-level PMI, provided the PMI issuer is a regulated mortgage insurance company, is not an affiliate of the banking organization, and (i) has long term senior debt (without credit enhancement) that has external an external rating that is in at least the third-highest investment grade rating category or (ii) has a claims-paying rating that is at least the third-highest investment grade rating category.”

As we have noted above, the NRSRO models have proven deficient in their ability to accurately stress test mortgage-related risk. Because of these serious deficiencies in assessing long term mortgage-related risk, it is inappropriate to use ratings as a criteria for setting regulatory capital.

As the SEC has recognized:

“Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear disadvantages of using the term in many of our regulations. Foremost, there is a risk that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to

² Basel Committee on Banking Supervision, *The Joint Forum, Credit Risk Transfer, Developments from 2005 to 2007*, published July 2008.

place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events, there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process."³

In response to these concerns, the SEC has proposed to eliminate all reference to NRSROs and their ratings from most of its regulations including the net capital rules that apply to broker-dealers. MICA has issued a comment in support of the SEC proposal.⁴ Similarly, the President's Working Group on Financial Markets recently reaffirmed the importance of reviewing the use of credit ratings in regulations and supervisory guidance to ensure that investors develop and independent view of the risk characteristics of the instruments in their portfolio rather than relying solely on credit ratings and appreciate the different risk characteristics of different types of instruments.⁵

MICA members strongly believe that investor and regulatory judgments based on review of claims-paying capacity – as evident by MI capitalization – justifies ongoing reliance on regulated MI as a form of credit risk mitigation for purposes of setting factors such as eligible investments or regulatory capital. In keeping with the expressed concerns about the NRSRO ratings as noted by the SEC and other members of the President's Working Group on Financial Markets, MICA recommends that the bank regulators amend the definition of eligible private mortgage insurers to exclude reference to NRSRO ratings and instead define it as follows:

Coverage provided by a mortgage guaranty insurance company providing coverage against loss arising from mortgage loan defaults shall be a qualified credit risk mitigation if the company: (a) is organized and domiciled in one of the United States as a monoline insurer authorized solely to transact private mortgage insurance; and (b) does not at any time have outstanding a total liability, net of reinsurance, under its aggregate mortgage guaranty insurance policies exceeding twenty-five (25) times its capital, surplus and contingency reserve.

³ 73 Federal Register 40088.

⁴ MICA comment letter to the SEC dated September 5, 2008.

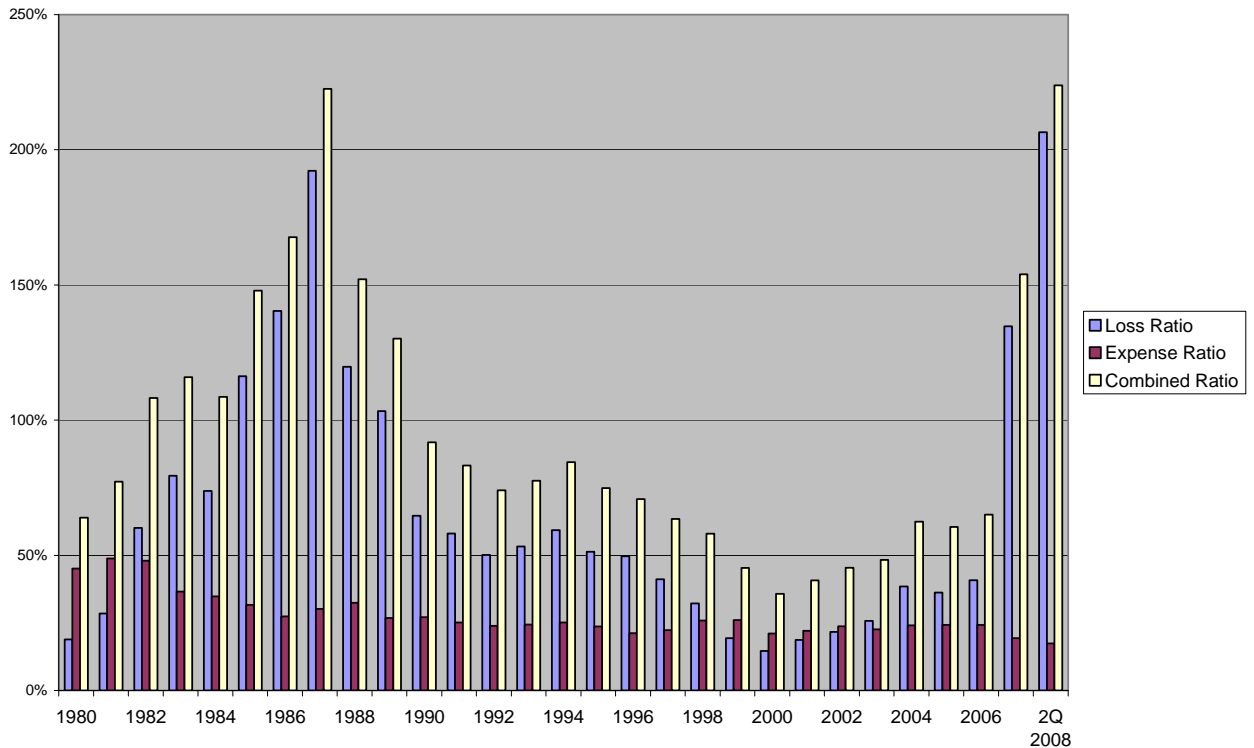
⁵ Progress Update on March Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets, October 10, 2008.

B. Health of the MI Industry

The current mortgage market stress is negatively affecting the earnings of the private mortgage insurance industry but not its claims paying ability. The industry has weathered past periods of house price decline and broader economic downturns, and its current reserves and premium income provide ample coverage to meet claims obligations, even in the current environment.

The chart below shows key ratios for the MICA member firms through the second quarter of 2008:

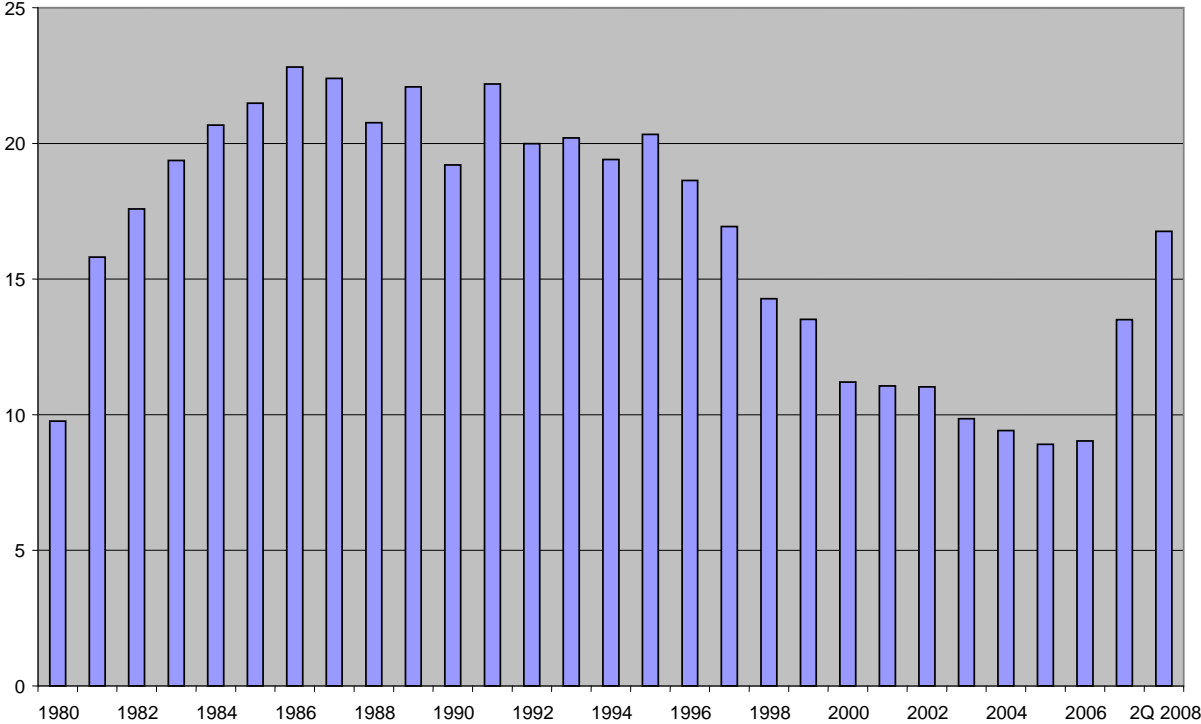
Chart 1: Key Annual MI Industry Ratios



As can be seen, the combined ratio for the entire industry (losses as a percentage of premiums earned and expenses as a percentage of premiums written) is currently as high as was experienced during the oil patch decline of the mid-1980s. However, note that the annual combined ratios exceeded 100% or more for eight straight years beginning in 1982 and the industry paid all claims and grew during that period. The reason for the continued strong claims paying ability of the MI industry is tied to its capital and reserve requirements.

Chart 2 below shows the risk to capital ratio for the industry which stands at 16.8 to 1 -- below levels seen in the mid-1990s, well below the levels reached during the mid-1980s regional house price declines and well below the maximum ratio mandated by regulators of 25:1.

Chart 2: MI Industry Risk to Capital Ratio



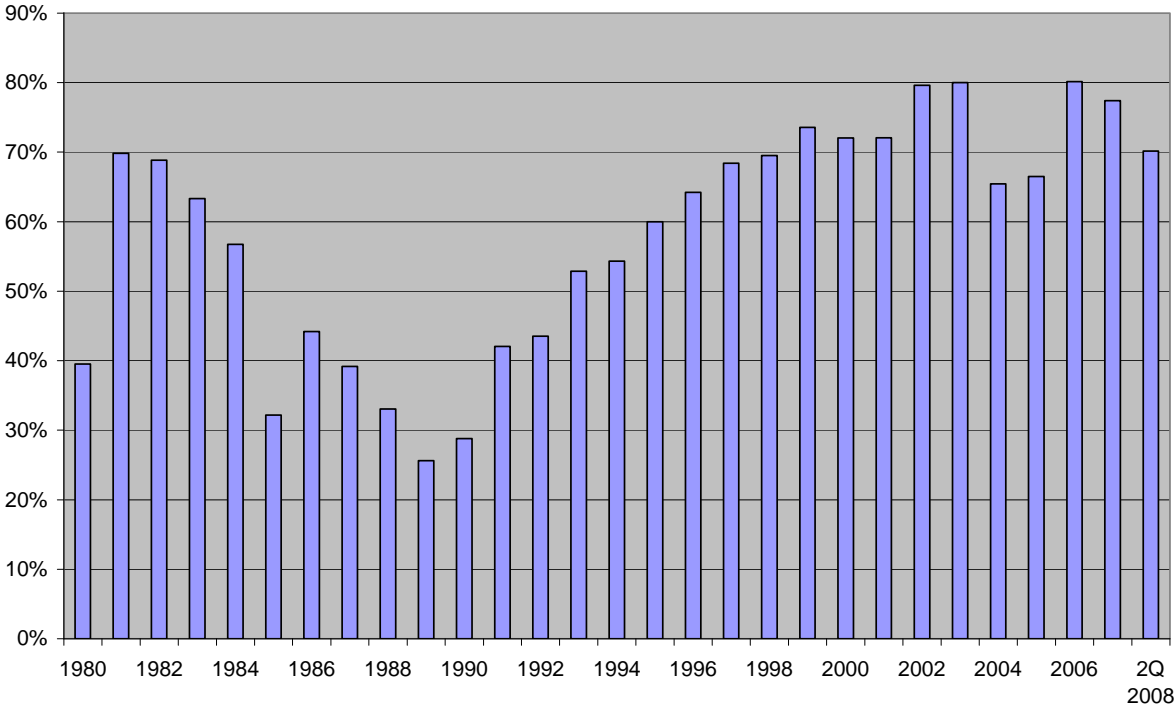
The reason risk to capital can still be low as the combined ratio has risen is tied to the regulatory capital requirements for the MI industry.

In light of recent market developments, many foreign leaders and financial regulators have voiced concern that banks and other financial institutions need to build capital in good times as a buffer for bad times using predictable rules. They acknowledge that supervisory frameworks need to be counter-cyclical, not pro-cyclical, as are many of the current Basel II guidelines. U.S. private mortgage insurance companies are, in fact, counter-cyclical by design. U.S. Model Insurance Act regulations specify that MI companies set aside 50% of premium earned into contingency reserves for a period of ten years, with early withdrawals limited to covering losses in excess of 35% of earned premium. Companies may also petition for earlier release of limited amounts of reserves in those cases where total capital held relative to risk outstanding is significantly beyond specified requirements. Therefore, unlike other financial institutions that may

pay high dividends during profitable periods, MI companies build their contingency reserves during these periods in order to have the capital ready to pay the higher claims that inevitably occur during periods of market corrections such as the one the U.S. is now experiencing.

Chart 3 below shows the contingency reserve for the industry as a percentage of total capital. The Chart shows that at the second quarter of this year the contingency reserves for the MICA-member firms stood at 70% of total capital which is far above the percentages that occurred during the mid-1980s and early 1990s high claim periods.

Chart 3: Contingency Reserve as % Total Capital



These three charts combine to show how the industry’s statutory structure allowed it to handle the multiple regional recessions of the oil patch and California in the 1980s as well as the downturns that occurred in both New England and California in the early 1990s. Following the recession and associated losses of the early 1980s, the MI industry replenished its contingency reserves with premiums set at a level to better cover increased expected losses and reduce the

magnitude of the future unexpected losses which must be absorbed by the contingency provisions. Thus, even during the regional recessions in the Northeast and California in the 1990s, the industry has been able to steadily increase its contingency reserve. Consequently, the MI industry was in a stronger risk to capital position at the beginning of the current period of house price decline than it was in the 1980s and early 1990s prior to those periods of significant market stress.

C. Depth of MI Coverage is an Important Factor in Risk Weight Reduction

We strongly agree with the banking agencies that a banking organization should be able to reduce the loan amount of a residential mortgage exposure up to the amount covered by loan-level MI. In order to provide adequate benefit to reduce credit loss severity for unexpected losses, the banking agencies should assure that risk weight reduction 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 the cost 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.

III. Risk Weightings on Prudential First Liens

MICA recognizes the need for simplified assumptions and a limited number of risk weightings in the Basel Standardized rule. Thus, we concur with the agencies' decision that the lowest risk weighting for prudential first liens should be 20% for LTVs less than or equal to 60% with risk weights increasing as high as 150% for LTVs above 95%. Our previous comment letters have provided data analysis that validates these risk weights.

Also, in previous comment letters, we have noted the importance of considering the geographic concentration risk of mortgage holdings when setting risk parameters. Specifically with regard to the Basel II advanced-requirements advance notice of proposed rulemaking we have noted the inappropriate use of a 15% asset correlation factor in a geographically concentrated portfolio with work confirming this concern appearing in papers produced by Federal Reserve staff.⁶ We believe that geographic concentration risk is still a factor that should be added by bank examiners to the basic risk based capital calculation when assessing the capital risk in a bank's retained mortgage portfolio. This is consistent with the Pillar 2 requirements in the NPR, as well as the regulators' reserve authority to increase an individual institution's capital in relation to determined risk. It is, however, not one that is best levied on a loan-by-loan risk weight adjustment basis.

IV. Risk Weight for Second Liens

MICA supports the proposal to combine any stand-alone second liens with all more senior ones (regardless of who holds them) to determine LTV for purposes of assigning a risk weight. We believe that mortgage risk is determined primarily by the borrower's equity, not the loan structure and who holds portions of it. However, MICA also remains concerned that the proposed risk weightings for high-CLTV second liens do not reflect the full risk of such loans.

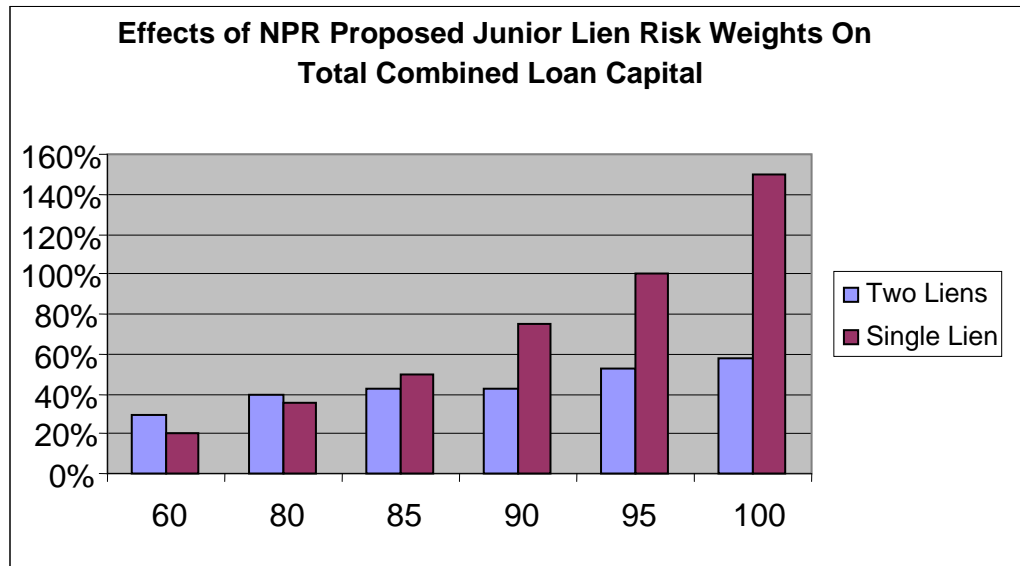
In MICA's Basel IA comments,⁷ we set forth the table below, which compares the risk weights of various single loans to alternative structured loans, as proposed in that NPR. The risk weights for first liens and the second liens are the same in the Standardized proposal as they were in the Basel IA proposal. Consequently, MICA's concerns remain the same. For the structured alternatives, the computed risk weight is the average of the first and second lien risk weights, weighted by the proportions of each in the combined loan amount. Under the proposed second lien risk weights in the Standardized proposal there remains a clear incentive for lenders to split their high LTV loans into

⁶ See MICA comment letter dated November 3, 2003 RE: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord. 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.

⁷ See MICA comment letter dated January 18, 2006.

two pieces and move one of them out of their portfolio, reducing risk-based capital (RBC) by as much as 61%.

Most Common							
CLTV	LTV for First and Second		NPR Proposal RWs			MICA Proposed RWs	MICA Proposed RWs
	First	2nd	First	2nd	Weighted Avg.	First Lien	2nd RW
60	50	10	20.0%	75.0%	29.2%	20.0%	20.0%
80	60	20	20.0%	100.0%	40.0%	35.0%	75.0%
85	75	10	35.0%	100.0%	42.6%	50.0%	200%
90	80	10	35.0%	100.0%	42.2%	75.0%	400%
95	80	15	35.0%	150.0%	53.2%	100.0%	400%
100	80	20	35.0%	150.0%	58.0%	150.0%	600%



The risk weights necessary to provide the necessary RBC is based on CLTV, regardless of whether a mortgage is structured as one transaction or on multiple loans that result in risk weights on second liens that appear to be disproportionately high but are not. For example, as set forth in the table above, a 20% second lien would need a risk weight of 600% in order to ensure appropriate capital of 150% for the mortgage as a whole. But to adopt any other approach would be to under-calculate capital simply because a loan has been broken into more than one piece. For high CLTV transactions, the PD on the first lien is amplified by reducing or extinguishing the borrower's equity through adding subordinate lien debt. That additional risk must be accommodated by increasing capital on the second lien in an amount sufficient to reflect the additional risk to the combined structure. What might appear to the uninitiated to be excessively high-risk weights is in

fact entirely appropriate given the demonstrated risk of simultaneous second structures.

One of the objectives of our suggestion is to avoid underestimating capital when one lender holds a first lien and another holds the second lien. Our approach ensures that the banking system holds sufficient capital against a given mortgage risk, regardless whether there is one lien or more, and regardless of whether the pieces are held by one or more banks. The Standardized proposal as currently proposed inadvertently creates incentives for lenders to take steps so that they can legitimately assert that they are unaware that a second lien exists, and assess capital on the basis of the first lien LTV instead of the actual CLTV. The risk weights MICA is proposing for second liens ensure sufficient capital in the banking system to cover the risk to the entire loan, regardless of whether structured as one lien or two liens, and these risk weights serve as a strong disincentive to avoid risk through structures that have the effect of adding “invisible” risk to the banking system.

V. Appropriate Risk Weights for Imprudent Mortgages

MICA has considerable concern that current RBC standards and even the leverage requirement do not adequately capture the economic risk of certain mortgage structures. It is for this reason that we urged the bank regulators to move separately on non-traditional mortgage capital standards, doing so in numerous comment letters to the banking agencies beginning in 2002. As noted at the outset of this letter, MICA believes that the disconnection between regulatory capital and mortgage risk was a causative factor in the current mortgage-market collapse and related macroeconomic and financial problems. Thus, we believe that the Basel capital rules should establish dollar-for-dollar capital requirements for those high LTV mortgages that do not meet prudent underwriting standards. This is analogous to comparable capital treatment for other high-risk assets.

In setting capital standards properly to reflect mortgage risk, the bank regulators should address the following risk factors which have proven to be predictive of both high probability of default and severity of loss on mortgage loans:

1. Combined Loan-to-Value: After the closing of a first, second or home equity line, when the CLTV is above 75%, the net realizable value of the home does not collateralize the mortgage note(s). The costs of foreclosure (these costs typically average 14-17% of the defaulted unpaid note balance) and the cost of selling the home (which typically

amounts to at least 10-12% of the appraised value) almost always equal or exceed 20% of the then-current appraised value of the home. For example, if the home does not appreciate, it will not collateralize even a debt of 80% of original value unless the borrower has significantly paid down the debt. Avoiding loss in lending to CLTVs higher than 80% in stable or appreciating markets and over 75% in declining markets requires that the homeowners not default on the note or else the lender will experience a loss. Therefore, CLTVs over 80% in stable markets and over 75% in declining markets require reliance on the credit worthiness of the borrower. The CLTV thus is among the most important indicators of risk because it clearly measures the collateralization of the note and it also indicates the likely willingness of the borrower to continue making payments. Borrower equity begins to disappear as the CLTV exceeds 75%, presenting the borrower with the option to either continue payment or turn the keys over to the lender. Many choose foreclosure, if they are having financial, health or marital problems or if the equity is negative and the alternative of renting appears to be a better economic choice. With the favorable tax treatment of interest on home loans (and the recently enacted law “forgiving tax” on the “forgiveness of debt”) and the impressive appreciation of home values, more and more homebuyers consider the home an investment and have less emotional attachment to it. Therefore, more homeowners abandon their investment when they owe more than it’s worth. It stands to reason, of course, that no mortgages should be underwritten that have CLTVs in excess of 97% as some minimal borrower equity investment should be involved in any mortgage loan. If loans with LTVs above 97% are underwritten, the capital treatment of such loans should be dollar-for-dollar even if none of the other risk factors noted below is evident in the underwriting. Any loan in a declining market with a CLTV over 75% is likely to be unsecured during the critical risk period (i.e., the first three years of the loan) and should have dollar-for-dollar capital.

2. Credit Score: The credit worthiness of a primary borrower as measured by FICO score is a good measure of the risk of default during periods of normal house price appreciation but not during periods of market stress. Consequently, as noted above, FICO scores are not a substitute for careful underwriting. However, low FICO scores should be considered as a significant risk factor. Additionally, certain minimum FICO scores—our experience would suggest a

score above 575-- should be applied to any high LTV loan regardless of the absence of other risk factors. Our experience leads us to believe that FICO scores between 575 and 660 can also be high risk but may be considered as prudent loans if no other high risk factors exist.

3. Declining Markets: As properties decline in value, the CLTV increases, often to levels where equity is exhausted. While lenders have great difficulty in predicting declining markets, once a market is in decline, this risk of likely, additional erosion in equity should be acknowledged in the underwriting of mortgage transactions.
4. Cashout Refinances: When borrowers take out equity from their home investment, they increase their CLTV and increase the risk of default. With a CLTV at or above 90%, most borrowers would realize more cash from a cashout refinance than they would realize from a sale of the property, which makes this a high risk feature of mortgage transactions when CLTVs are over 75%.
5. Non-conforming adjustable rate mortgages: Adjustable rate mortgage (ARM) products that create too much payment shock or too little amortization (or even negative amortization) add significant risk to mortgage transactions. The current housing problems are in large measure attributable to the dangerous design of 2/28 and 3/27 arm loans and to teaser rate option arms which are resulting in increased payments and increased loan balances as home values are falling.
6. Excessive Borrower Debt- to- Income Ratios: The amount of income needed to make the mortgage payment is a telling statistic. As the FDIC has noted in its requirements for structuring troubled mortgages, a restructured mortgage should not put the borrower in a debt-to-income ratio (DTI) greater than 38%. MICA supports the capping of DTI ratios at 38% for restructured and high-risk mortgages and believes that DTI can be measured against the borrower's credit history to require lower DTI ratios for lower credit scores. Additionally, first-time borrowers with less demonstrated skills of financial management should be required to have more residual income to offset their inexperience in managing the financial strains of home ownership.

7. Reduced Documentation of Borrower Income and Assets: Reduced documentation requirements for borrowers were meant to circumvent the problems of underwriting borrowers with complicated incomes, such as the self employed. However, like many other mortgage underwriting factors, it has been abused and has become a high-risk factor. Prudent underwriting requires that the use of this practice be limited only to self employed borrowers and then only when none of the other risk-factors noted above is part of the mortgage financing.
8. Non-Owner Occupant and Other Risk Factors: A loan to a non-owner occupant that is not for a home intended to be a vacation home for the borrower is a high risk factor as the property is really an investment property rather than one intended to be used for occupancy by the borrower. Additional high risk factors should be defined by the appropriate bank regulator given the experience of the institutions they regulate. An example may be the use of equity other than the borrower's resources such as seller concessions, gift letters and down payments provided by borrower assistance entities.

In establishing new prudent underwriting standards for high LTV loans, the general rule should be that the higher the CLTV of the loan, the higher the required borrower credit scores and the fewer the other risks involved in the transaction. However, the high risk factors noted above present special risks to regulators, financial institutions and borrowers. MICA recommends that the bank regulators set dollar-for-dollar capital treatment when a loan has two or more of the above noted high risk factors. Not all loans containing any one of these factors should result in such treatment but a combination of these factors should put the loan into the dollar-for-dollar capital classification for the protection of the regulated financial institution holding the loan and for the protection of the potential borrower.

Conclusion

The current turmoil in the mortgage markets is being addressed in several ways even as the banking agencies are considering changes to the Standardize approach. MICA urges that the banking regulators take this opportunity to make sure that the Standardized approach provides the necessary incentives for mortgage market participants to properly assess the risk of mortgages originated going forward and that the regulatory capital reflect the true economic risk of these mortgages.

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

Appendix A to MICA Comment Letter Dated October 27, 2008 on Basel Standardized Approach as Applied in the United States

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

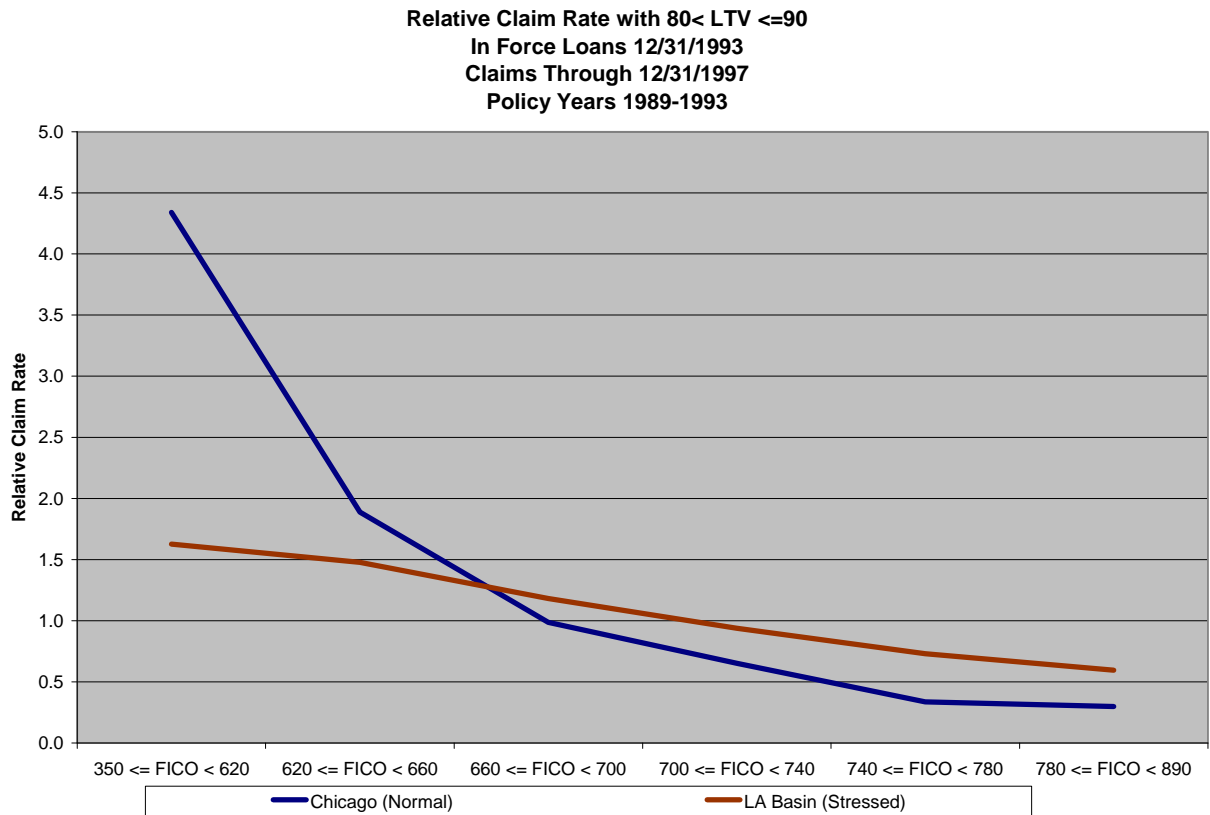
MICA members have analyzed their industry data and produced conclusive evidence that credit scores, while highly predictive of foreclosure rates under normal housing market conditions, lose much of their predictive power under stressed market conditions. Furthermore, the study shows that the impact of 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). All of the loans had original LTVs above 80% but not higher than 90%, all 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.

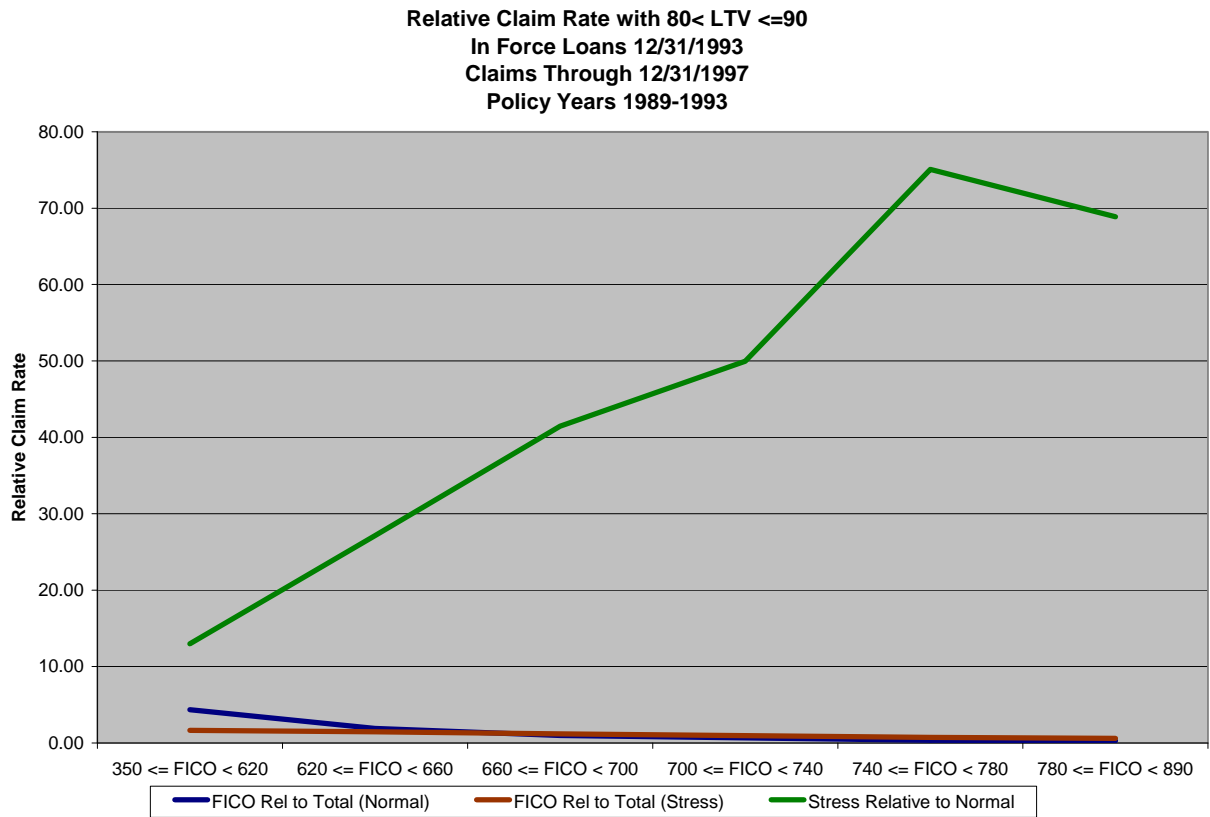
In Figure 1, we show the claim rate for each FICO range, relative to the overall claim rate for the market. In the normal market (Chicago), the lowest FICO range (<620) had a claim rate that was 4.34 times the overall claim rate for the market, while the claim rate for the highest FICO range (≥ 780) was 0.30 times the overall rate. This relationship corresponds well to the "expected" relationship between credit and PD. 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 credit 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.