Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

June 23, 2008

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 Seventeenth Street N.W.
Washington, D.C. 20429

Dear Mr. Feldman:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the FDIC's interim policy on covered bonds [73 Fed. Reg. 21949]. MICA supports the interim policy, which we think will further the FDIC's goal – shared with the President's Working Group on Financial Markets – of enhancing mortgage-market liquidity. This will, in turn, help to improve mortgage availability to borrowers and calm a critical sector of the nation's credit market. However, MICA would recommend a significant revision to the policy: require that all eligible mortgage collateral with high loan-to-value ratios carry a robust third-party credit enhancement, thus reducing reliance on the credit ratings agencies and their AAA designation.

MICA believes that this would reduce the risk to the FDIC in the event of a bank failure, as well as promote needed reform in the use of ratings-agency designations. There are all too many recent cases in which mortgage obligations without third-party credit enhancement were granted an AAA designation at origination, with the rating subsequently sharply reduced and investors forced to take significant write-downs. Reliance on third-party credit enhancement, including private mortgage insurance (MI), is not only consistent with recent regulatory actions to reduce ratings-agency dependence, but also with the new – and correct – focus on ensuring that there is capital at risk when assets are securitized.

1425 K Street, NW
Suite 210
Washington, DC 20005
(202) 682-2683
Fax (202) 842-9252

This important point was a major emphasis of the President's Working Group March report on financial-market improvements,[1] and we commend work now under way in the Basel Committee to implement this change. If the FDIC does not ensure that some form of private capital stands behind covered bonds, it will create the same type of incentives risk that has threatened current mortgage securitizations. Failing banks may be particularly tempted to seek yield advantages in AAA-rated mortgage positions that are, in fact, quite risky based on underlying underwriting factors or securitization tranching.
Should the FDIC subsequently need to close the bank and establish a conservatorship or receivership, it would be left with low-quality collateral and no recourse to any compensating source of private capital. If, in contrast, the initial obligations are backed by robust third-party credit enhancement under appropriate regulation and with sufficient capital, the credit enhancement provider's incentives are directly aligned with those of the FDIC: to ensure long-term, sustained credit quality. The FDIC thus would avoid undue credit risk and sharply reduce its resolution costs.

As noted, reliance on third-party credit enhancement – not determinations of the credit ratings agencies (CRAs) – is consistent with a new consensus among U.S. and global regulators. Chairman Bair has rightly addressed this in numerous venues, noting for example that, "[r]egulators may want to further review capital requirements that are based on external ratings for structured financings."[2] More broadly, the President's Working Group on Financial markets has stated, "[r]egulators should review the current use of ratings in regulation and supervisory rules."[3] The Federal Reserve concurs with this consensus, with Chairman Bernanke recently stating, "[w]e will review our own use of credit ratings as a risk metric."[4]

Ratings-agency determinations have been particularly problematic in the mortgage arena. Since mid-2007, more than $50 billion in securities backed by alt-A mortgages have been downgraded[5] with so-far uncounted billions more in investment-grade and subprime

---

[1] President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (2008).
[2] Sheila Bair, Remarks to the Bear Stearns Mortgage and Structured Product Conference (January 17, 2008).
[3] President's Working Group on Financial Markets, Policy Statement on Financial Market Developments at 6 (2008).
[4] Ben S. Bernanke, Addressing Weaknesses in the Global Financial Markets: The Report of the President's Working Group on Financial Markets, Speech Before the World Affairs Council of Greater Richmond (April 10, 2008).
[5]Forbes.com, *Subprime In Sheep's Clothing* (May 8, 2008), *available at* http://www.forbes.com/business/2008/05/08/alt-a-mortgage-markets-bonds-cx_md_0506markets32.html.

paper similarly meeting this fate. These downgrades all too often result in assets moving from investment-grade status to junk in a single ratings-agency action. As the FDIC knows all too well, market estimates now place total losses resulting from the mortgage-market debacle at $300 billion or even more, and much of this results from securitization positions initially granted very high ratings. Second liens are a particularly good case in point. Here, S&P recently announced that it would completely cease to rate second liens going forward because its models were woefully incapable of reaching any meaningful credit-risk determination. However, the agency declined to remove its ratings on all of the second-lien paper previously rated with precisely the same models. As a result, the FDIC could find itself accepting as collateral initially highly-rated obligations backed by a model now disavowed by the credit ratings agency.

In contrast, third-party credit enhancement ensures long-term capital is available to support collateral quality. Despite the serious stress now apparent in the mortgage market, MICA members have unquestioned claims-paying ability because of high capital and significant reserves. As of year-end 2007, MICA members held $13.6 billion in total capital and $8.5 billion in loss reserves positioned against $185.4 billion of insurance risk in force. MIs are subject by law to a uniquely strong reserve requirement that adds to basic capital standards since mortgage losses tend to concentrate during periods of high default rates. The law generally requires that fifty percent of every premium dollar generated by mortgage insurers be put into a contingency reserve and not accessed for 10 years. This system has allowed mortgage insurers to build reserves over the last fifteen years. As a result, MIs have a capital-to-risk ratio of 7.3 percent without taking into account the loss reserves – a ratio that compares very favorably to that at insured depositories for mortgage assets.

Importantly, mortgage insurance is not only backed by strong capital and reserves, but also a form of credit enhancement singularly focused on mortgage credit risk. In sharp contrast to credit derivatives, MI is not a nominal form of credit risk transfer that can be sold to third parties and converted into a trading asset. The Joint Forum of global banking, securities and insurance regulators has rightly focused on the problematic nature of credit derivatives.[6] We urge the FDIC to ensure that it relies on proven forms of third-party credit enhancement in assessing collateral eligibility for all covered bonds.

MICA would be pleased to provide additional information and otherwise be of assistance as you finalize the covered-bond policy and

[6] Joint Forum, Credit Risk Transfer (2005).

advance the shared objective of improving the liquidity and efficiency of the U. S. residential-mortgage market.

Sincerely,

Suzanne C. Hutchinson