Mortgage Insurance Companies of America

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Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2–3
Washington, DC 20219
Docket No: OCC– 2009–0012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No: R–1368

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064– AD48

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS– 2009–0015

Ladies and Gentlemen:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the notice of proposed rulemaking (NPR) to address the array of issues posed by recent changes in U.S. accounting rules.[1] MICA is the trade association representing the U.S. private mortgage insurance (MI) industry. MIs are state-regulated insurance companies that provide insurance against default risk on high loan-to-value (LTV) residential mortgages, doing so since 1957 to support a liquid, efficient U.S. mortgage market that deploys capital effectively to support prudent home ownership.

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[1] Risk-Based Capital Guidelines; Impact of Modifications to Generally Accepted Accounting Principles; and Other Related Issues, 74 Fed. Reg. 47,138 (Sept. 15, 2009).

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Mortgage insurers have been perhaps the only major providers of credit-risk protection and holders of high-LTV mortgage risk in the U.S. to have withstood recent market shocks. To be sure, the recent extreme-stress scenario has strained private MIs, but MIs are not only paying all valid claims now, but also have the capital capacity to pay those expected throughout the remainder of the mortgage-market crisis. This claims-paying capacity results in large part from the fact that MIs – unique among regulated providers of credit risk mitigation – have long been subject to counter-cyclical capital requirements. This experience under unprecedented market stress demonstrates the vital role of ample capital to withstand credit risk, and it underpins MICA's support for the overall thrust of the NPR to reflect recent rulings by the Financial Accounting Standards Board (FASB) in the agencies' capital regulations.

We shall below provide more detail on MICA member experience and the issues presented in the NPR. Key points include:

- MICA supports rigorous bank-regulatory capital requirements that reflect real risk, taking into account non-contractual credit risk positions that have proven very costly. FASB's consolidation requirements[2] reflect recent market experience and should generally be reflected by the bank regulators.

- However, the regulatory-capital approach to implement the FASB rule should follow prior bank requirements and recognize the value of proven forms of capitalized credit risk mitigation like MI. Thus, it is appropriate to focus principally on risk-based capital, not the leverage requirements. To the extent current capital rules do not reflect the role of MI in complex structures now being brought on to the balance sheet, the regulators should address this in the final rule implementing the NPR, not wait for the next round of Basel II rulemakings. This can be done most easily by requiring regulators to reflect the value of MI and other proven forms of credit risk mitigation on a case-by-case basis under the reservation of rights section of the NPR.

[2] Financial Accounting Standards Board [FASB], Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* [FAS 166], and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46R* [FAS 167] (June 12, 2009).

- MICA supports the proposed exemption for government-sponsored enterprise (GSE) securitizations from consolidated obligations for capital purposes, but believes that other securitization structures with private capital at risk should be similarly exempted.

- The final rule should ensure that it is not duplicative of any new risk-retention requirement when MI or other proven forms of credit risk mitigation are in place. MI is capital at risk that meets the goal of reforming the originate-to-distribute model. Indeed, reliance on proven forms of third-party capital to ensure proper risk-incentive alignment meets the objectives of pending risk-retention proposals without the adverse overall market impact identified in recent regulatory assessments of this concept.[3]

- MICA supports the proposed exemption from consolidation for modified mortgages. This will facilitate loan modifications, reducing foreclosure rates and benefiting the housing-market recovery.

- Any phase-in period should be as short as possible to avoid any new mortgage structures that permit capital arbitrage against direct or indirect credit risk held by the lender, issuer or securitizer.

I. MICA Supports Disciplined Regulatory Capital That Reflects Proven Credit Risk Mitigation

As noted, MICA supports the thrust of the NPR's broad framework and we will below provide our views on several of the questions asked that relate to it. We endorse the disciplined approach bank regulators are now proposing to take to off-balance sheet obligations, reflecting new FASB rules. As has been all too sadly evident in the ongoing crisis, credit risk mitigation that is not backed by proven forms of capital provided through counter-cyclical structures is of little use under severe market stress. Even worse, non-contractual credit-risk supports – implicit recourse, as the regulators rightly call it – was a

[3] *See* International Organization of Securities Commissions' [IOSCO], Technical Committee, *Unregulated Financial Markets and Products*, Final Report (Sept. 2009), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf, *see also* International Monetary Fund, World Economic and Financial Surveys, *Global Financial Stability Report, Navigating the Financial Challenges Ahead*, ch. 2 Restarting Securitization Markets: Policy Proposals and Pitfalls (Oct. 2009), *available at* http://www.imf.org/external/pubs/ft/gfsr/2009/02/index.htm.

dominant theme in a wide array of asset structures designed to avoid capitalized credit risk mitigation. The market relied on firms to honor these non-contractual commitments due to fear of subsequent repercussions such as higher funding costs, reduced counterparty reliance and similar measures. This reputational risk was compounded by legal risk because many seemingly non-contractual commitments were in fact backed by verbal agreements or other assurances, leading banks to honor these commitments out of fear not only of adverse counterparty reaction, but also due to legal risk.

Starting as early as 1996, global and U.S. bank regulators recognized that the very generous approach to off-balance sheet commitments in the Basel I rules[4] created a strong incentive to regulatory-capital arbitrage.[5] This is because off-balance sheet commitments (e.g., letters of credit) only trigger risk-based capital when maturities exceed 365 days. Unsurprisingly, virtually all off-balance sheet instruments shifted to maturities of less than 365 days as soon as the Basel I rules were finalized in 1988. Further, since off-balance sheet obligations (regardless of maturity) were not factored into the U.S. leverage requirement[6] an incentive was created in the U.S. not only to shorten off-balance sheet maturities, but also to put as many obligations off the balance sheet as possible.

These incentives had an array of adverse market implications, leading regulators, as noted, to highlight revisions to off-balance sheet regulatory capital in the earliest consultative paper on the Basel II Accord in 1999.[7] The long delay finalizing Basel II, however, meant that the initial Basel I treatment remained in place unchanged until 2007 outside the U.S. and largely to this date in this nation. Combined with increased market interest in highly-complex financial instruments (e.g., structured investment vehicles), this regulatory-capital treatment, combined with poor liquidity-risk management, posed profound risk that quickly and disastrously translated into systemic risk during the fourth quarter of 2008.

MICA has consistently urged bank regulators to take an array of actions to reform regulatory capital. We thus not only support the NPR, but also urge the banking agencies quickly to turn to the long-

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[4] Basel Committee on Banking Supervision [BCBS], *International Convergence of Capital Measurements and Capital Standards*, Basel Capital Accord (July 1988, rev. Apr. 1998), *available at* http://www.bis.org/publ/bcbsc111.pdf?noframes=1.
[5] *See generally,* Patricia Jackson, *Capital Requirements and Bank Behavior: The Impact of the Basel Accord*, (BCBS, Working Paper No. 1, 1999), *available at* http://www.bis.org/publ/bcbs_wp1.pdf?noframes=1.
[6] FDIC Minimum Leverage Capital Requirements, 12 C.F.R. § 325.3 (2009).
[7] BCBS, *A New Capital Adequacy Framework*, Consultative Paper (June 1999), *available at* http://www.bis.org/publ/bcbs50.htm.

overdue task of updating U.S. capital standards for all banking organizations, regardless of size. We shall here confine our views to the specific capital issues raised by this NPR, but we would be pleased to provide additional views on other topics as appropriate.

II. The NPR Is Appropriately Risk-Based

Unless and until U.S. leverage and risk-based capital regulations are revised to remedy the many problems that created undue incentives to risk-taking and insufficient reliance on robust capital instruments, the final rule implementing the FASB consolidation requirements should ensure that bank capital is efficiently deployed and provide relief for newly-consolidated positions backed by regulated, capitalized providers of proven forms of credit risk mitigation.

In general, the NPR would address the capital implications of consolidating assets by changing risk-based capital (RBC) requirements, leaving the leverage standards as is. MICA supports this, in part because strains in credit markets, especially the mortgage area, would be worsened if leverage capital requirements were suddenly adjusted to reflect hundreds of billions of dollars in off-balance sheet obligations. Any such requirement could not only freeze credit markets, but also make it far more difficult going forward for securitization to recover in tandem with a strengthened financial market.

Because of the focus on RBC, a final rule along the NPR's lines would appropriately reward banks that have taken out proven forms of credit risk mitigation which, like MI, are currently reflected in bank capital rules. This not only reflects correct incentives, but also rightly conserves bank capital without resulting risk. When private capital is at risk, as is the case with MI, a bank's RBC should be significantly reduced to permit it to support the greatest possible amount of prudent lending. This is vital not only under ordinary market circumstances, but especially so as regulators struggle to support macroeconomic and market-segment recovery.

III. Risk-Based Capital For Consolidated Securitized Positions Should Reflect Capitalized Credit Risk Mitigation

Unfortunately, current U.S. RBC requirements for securitized and/or structured obligations generally do not reflect proven forms of credit risk mitigation, instead generally relying on credit-ratings-agency (CRA) determinations to set RBC for asset-backed securities (ABS),

including mortgage-backed securities (MBS). This is particularly true for the vast majority of U.S. insured depositories, for which a 2001 revision to the capital rules continues to determine RBC for ABS.[8] However, it is unfortunately also true for the very largest U.S. institutions, which have yet to even begin to comply with the advanced internal-ratings based provisions in the final U.S. version of the Basel II rules.[9] Until the U.S. rules are implemented – which may be very far off in light of plans now to rewrite much in Basel II – all U.S. banks essentially set RBC for securitized positions based on credit ratings.

MICA will not here dwell on all of the methodological and business-model issues that have led many U.S. and global regulators to seek rapid evolution from regulatory CRA reliance.[10] We have filed comment letters with international and domestic regulators (e.g., the Securities and Exchange Commission) on this point and we believe now that regulators share our goal of setting RBC to reflect real capital at risk, not just untested models that lack sufficient historical data and/or fail to employ rigorous stress testing. However, unless or until the rules are changed, consolidated positions will come under RBC rules premised principally on CRA determinations, which means that bank capital may be wholly disproportionate to real risk. To the degree capital is unduly high post-consolidation, the resources of insured depositories will be even more strained and, thus, less able to support market recovery.

To prevent this, MICA recommends that the agencies revise and expand the reservation of authority provided in the NPR.[11] Specifically, we urge the agencies to make clear that they will, on a case-by-case basis, adjust RBC when an ABS or MBS is consolidated to reflect existing or acquired credit risk mitigation. Doing so on a case-by-case basis avoids the complexity of issuing a rule now to clarify how this will be done, and MICA believes it is not necessary to slow down a final rule or otherwise complicate it to address this critical issue. However, we suggest that the final rule make clear that the agencies will provide capital relief for ABS and MBS only when credit risk mitigation is provided by a capitalized, regulated provider, not providing RBC reduction for positions backed by credit default swaps (CDS), excess-spread structures or other structures that lack proven credit-risk absorption capacity, especially under stress

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[8] FDIC Statement of Policy on Risk-Based Capital, 12 C.F.R. pt. 325 app. A (2009).
[9] Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007).
[10] *See* IOSCO, Technical Committee, *The Role of Credit Ratings Agencies in Structured Finance Markets*, Final Report (May 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf.
[11] 74 Fed. Reg. 47,138, at 47,144.

In this connection, we would note the enhancements to the Basel II Accord recently finalized by the Basel Committee.[12] This important reform to Basel II rightly addresses the risks posed by complex securitization and resecuritization structures in which ratings and/or uncapitalized credit risk mitigation are employed to persuade investors that risk is limited or even remote. Short-term action now by U.S. regulators to reflect real credit risk mitigation in newly-consolidated ABS positions is consistent with the Basel II reform and will make it easier for the U.S. quickly to improve the risk-sensitivity of the RBC regime once a broader reform effort commences.

Although we believe capital relief for ABS now should be provided on a case-by-case basis, MICA suggests that the agencies provide guidance on how capital relief will in general be provided to ensure consistent treatment by all of the agencies and provide up-front guidance to the market. Broad principles expressed with regard to the proposed reservation of authority will prevent confusion or, worse, regulatory arbitrage. And, with advance guidance, institutions will have the necessary initial assurance that efforts to obtain credit risk mitigation for newly-consolidated positions may be rewarded through subsequent RBC reduction. Absent such initial assurance, stressed institutions may be reluctant to divert resources to obtain proven, capitalized credit risk mitigation, thus undermining their capital efficiency and, of course, their ability to contribute to the market and macroeconomic rebound.

IV. The Proposed Exemption For GSE Securitizations Should Be Retained

Before turning to the questions posed in the NPR, MICA would like to comment on one final aspect of the proposal itself: the treatment of MBS backed by the GSEs. We strongly support this for the following reasons:

- First, Fannie Mae and Freddie Mac are vital to mortgage-market recovery. Regulators must ensure that bank originators can freely securitize qualifying mortgages to the GSEs, especially those that consist of refinanced loans designed to prevent otherwise-avoidable foreclosures.

- Secondly, mortgages sold to the GSEs are generally true sales. When this is not the case – i.e., when the originator retains recourse or holds a participation in a high-LTV loan

[12] BCBS, *Enhancements to the Basel II Framework*, (July 2009), *available at* http://www.bis.org/publ/bcbs157.pdf?noframes=1.

– current RBC and leverage capital rules already reflect this risk. In fact, the 2001 rules related to ABS cited above addressed this well, revising RBC to reflect the real risk in recourse structures, eliminating a regulatory-capital arbitrage in place up to that point. Absent recourse or participation, a mortgage sale to a GSE is a "true sale" under applicable FASB rules and thus should not be subject to any capital penalty.

- The new FASB rules will likely require consolidation of securitization positions by Fannie Mae and Freddie Mac, as their regulator indicated in its examination report to Congress earlier this year.[13] Any RBC requirement applicable to bank originations for the GSEs would be duplicative of this requirement and make securitizations through Fannie Mae and Freddie Mac so capital-inefficient as to forestall virtually all GSE-securitization activity. Again, Fannie Mae and Freddie Mac are critical to the U.S. mortgage market, and care must be taken to preserve this role as housing finance begins to recover.

Of course, GSE securitization structures at present may not be those used in future market conditions. We urge the regulators to be vigilant and revisit the issue of GSE securitizations for purposes of this consolidation requirement in the event insured-depository originators of mortgages sold to the GSEs deploy any risk-retention structures other than the recourse or participation ones provided in the Fannie Mae and Freddie Mac charters.[14] Any novel form of risk-share not now used in the market or well understood by bank regulators and the Federal Housing Finance Agency (FHFA) could pose significant new risks not now captured under current RBC and leverage requirements.

V. Risk-Retention Requirements Must Be Carefully Crafted.

MICA now turns to several of the questions posed in connection with the NPR, first addressing the potential impact of the consolidation rule on pending proposals to impose specific risk-retention requirements on originators, issuers and/or securitizers of ABS. These proposals have surfaced in various arenas, most importantly in

[13] *See* FEDERAL HOUSING FINANCE AGENCY, 2008 REPORT TO CONGRESS, *available at* http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf.

[14] Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 *et seq.*, Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 *et seq.* (2009).

President Obama's package of financial-industry reform legislation[15] and the recent Treasury policy on improvements to the U.S. regulatory-capital system.[16]

These risk-retention proposals are part of urgently needed reform to the originate-to-distribute model of asset securitization. Perhaps first cited in a March, 2008 report from the President's Working Group on Financial Markets,[17] risk retention is now widely – and correctly – seen as a way to ensure that private capital is at risk throughout the origination and securitization process. This aligns originator and issuer incentives with those both of the initial borrower and the ultimate ABS investor, preventing the undue reliance on CRAs or speculative ABS structures that have now cost financial markets hundreds of billions of dollars and threatened global prosperity.

However, it is vital to remember that private capital at risk can come not just from originators and issuers, but also from others brought into the securitization process. In mortgage securitization, private mortgage insurance plays precisely this role.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Half of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times not only to handle claims under stress, but also to avoid boom-bust cycles. 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.

Mortgage insurers are subject to mortgage-default risk similar to that at banks but only mortgage insurers raise capital counter-

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[15] U.S. Department of the Treasury [Treasury Department], *Investor Protection Act of 2009, Title IX Additional Improvements to Financial Markets Regulation, Subtitle E – Improvements to the Asset-Backed Securitization Process*, (July 22, 2009), http://www.financialstability.gov/roadtostability/regulatoryreform.html.

[16] Treasury Department, *Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms*, (Sept. 3, 2009), http://www.treas.gov/cgi-bin/redirect.cgi?http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf.

[17] Treasury Department, President's Working Group on Financial Markets, *Policy Statement on Financial Markets Development*, (Mar. 13, 2008), http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

cyclically. Bank regulators are only now working to construct a similar system for banks in the U.S. and around the world.

The history of the MI industry proves that it has paid valid claims through good and bad economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated – particularly in energy-oriented regions of the country – defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims, primarily in California and the Northeast. Policyholders included the GSEs, commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, and the Federal Deposit Insurance Corporation.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults and when foreclosures occur. Premiums received for the term of a policy are placed in unearned premium reserves. Each state establishes the method by which premiums are earned to match premiums with loss and exposure.

Beyond the reserve requirements, state regulators have detailed and comprehensive regulations designed to protect policyholders. State insurance regulation addresses among other things, the licensing of companies to transact business, policy forms, claims handling, financial statements, periodic reporting, permissible investments, adherence to financial standards, and premium rates. The premium rates and policy forms are generally subject to regulation in every state and are intended to protect policyholders against the effects of excessive, inadequate or unfairly discriminatory rates and to encourage competition while promoting sustainable and affordable housing.

All of this means that MI is proven capital at risk that ensures appropriate incentive alignment over the life of a mortgage loan and MBS. It is critical to ensure that regulatory RBC or similar capital requirements are not duplicative of this capital or, as with GSE securitizations, regulatory capital will be so inefficient and dissociated from risk that mortgage lending will be very adversely affected. Capital should reflect real risk throughout the life cycle of an asset securitization, but not force entities that do not in fact hold risk to hold capital. When MI or other forms of regulated, capitalized credit risk mitigation stand in the stead of an originator or securitizer this capital should be fully reflected in the banking agencies' rules with appropriate

reductions in RBC and/or risk-retention requirements for banks acting as originators or issuers of mortgage-backed securities.

VI. Modified Mortgages Should Not be Consolidated

In another question in the NPR, the agencies ask if mortgages being modified in connection with the Administration's Making Home Affordable Program[18] should be reflected in leverage and/or risk-based capital if the modification forces consolidation under GAAP. MICA urges regulators to defer any action in this area until the current crisis has abated. While we strongly support disciplined regulatory capital that fully reflects risk, we do not believe it timely to exacerbate capital stress at banks and, thus, limit their ability to modify mortgages and make new loans. To ensure an appropriate capital framework for modified mortgages that does not undermine ongoing recovery efforts, MICA suggests that the banking agencies address this issue in the pending rewrite of U.S. capital rules, a rewrite not likely to be finalized until regulators can better assess the condition of the mortgage market and remaining risk for borrowers in otherwise-preventable foreclosure situations.

VII. The Phase-In for Consolidated Capital Should Be as Short as Possible

Finally, the NPR seeks views on when the agencies should impose their final rule. MICA would, as noted, recommend that the agencies provide for only a limited phase-in period to ensure that regulatory capital is as closely linked to real risk as possible. We respect the need to change rules gradually under current market circumstances because, as discussed throughout this comment letter, MICA fully understands the fragility of current financial markets and the need banks have for limited capital resources to support new lending and, with it, economic recovery. However, if regulatory flexibility outlasts the current crisis, new opportunities for regulatory-capital arbitrage will emerge. We thus recommend addressing the issue of loan modifications – for all retail loans, not just mortgages – in the capital proposals anticipated shortly from the banking agencies.

VIII. Conclusion

MICA would be happy to provide any additional information or assistance to the banking agencies in connection with this important rulemaking and with others related to regulatory capital. We strongly support the intent of this NPR – to ensure that regulatory capital

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[18] Treasury Department, *Making Home Affordable Program, Home Affordable Modification Program Guidelines*, (Mar. 4, 2009), http://www.treas.gov/press/releases/reports/modification_program_guidelines.pdf.

reflects real risk – and we urge quick action not only on it, but also on other regulations to enhance the risk-sensitivity of federal regulatory-capital requirements for banks and other financial-services firms. We believe that the counter-cyclical capital required of private mortgage insurers is an example of how regulatory capital can ensure ability to meet claims even under unprecedented stress scenarios and we look forward to working with the agencies as they address not only new regulatory-capital requirements, but also the risk-retention standards discussed above.

Sincerely,

Suzanne C. Hutchinson