



**Mortgage  
Insurance  
Companies  
of America**

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January 18, 2006

Office of the Comptroller of the Currency  
Mailstop 1-5, Attention: Docket No.05-16,  
250 E Street, S.W.  
Washington, DC 20219  
Via email to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov)

Ms. Jennifer J. Johnson, Secretary  
Attn: Docket No. R-1238  
Board of Governors of the Federal Reserve System,  
20th and Constitution Avenue, NW  
Washington, D.C. 20551  
Via email to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

Robert E. Feldman, Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, D.C. 20429  
Via email to [Comments@FDIC.gov](mailto:Comments@FDIC.gov)

Regulation Comments  
Attention: No.2005-40  
Chief Counsel 's Office  
Office of Thrift Supervision  
1700 G Street, N.W.  
Washington, D.C. 20552  
Via email to [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

RE: Docket No. 05-16  
Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital  
Maintenance: Domestic Capital Modifications

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the joint advanced notice of proposed rulemaking (ANPR) by the bank regulatory agencies (Agencies) concerning revisions to the existing risk-based capital framework that would enhance its risk sensitivity (Basel IA). MICA is the trade association of the private mortgage insurance (MI) industry<sup>1</sup>.

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<sup>1</sup> Six private mortgage insurers comprise MICA: Genworth Mortgage Insurance Corporation, Mortgage Guaranty Insurance Corporation, PMI Mortgage Insurance Co., Republic Mortgage Insurance Company, Triad Guaranty Insurance Corporation, and United Guaranty Corporation

Our comments noted below build upon those we made in our July 31, 2003 comments to the Basel Committee on the third consultative paper (CP3), our November 3, 2003 comments to the Agencies concerning implementation of the new Basel accord in the United States, and our January 25, 2005 comments to the Agencies on the proposed supervisory guidance for banking entities that would use the internal-ratings-based approach to determine their regulatory capital requirements for retail credit exposures under Basel II.

At the outset, MICA would like to express its strong support for the goal of the ANPR: enhancing the risk sensitivity of the existing risk-based capital framework. We also strongly support the five broad principles that guided the Agencies in proposing revisions to the domestic risk-based capital rules: (1) promote safe and sound banking practices and a prudent level of regulatory capital, (2) maintain a balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) create appropriate incentives for banking organizations, and (5) mitigate material distortions in the amount of regulatory risk-based capital requirements for large and small institutions. MICA has applied these same principles in developing our recommendations below.

We also want to commend the Agencies for their careful consideration of the risks inherent in residential mortgage loans, especially low-downpayment loans. Throughout the Basel capital reform process, MICA and its member companies along with others have expressed concern that the regulatory capital changes improve the alignment of regulatory and economic capital. Under the existing risk-based capital standards, regulatory and economic capital are not well aligned, creating few incentives for effective credit risk management. The Agencies have proposed significant steps to redress this serious flaw through recognition of proven forms of credit risk mitigation, and we note in particular the proposed treatment of mortgage insurance in this regard. Although it is important that the IA proposal avoid the complexity that is problematic in Basel II, it should still contain capital recognition for proven forms of credit risk mitigation like MI to create correct regulatory capital incentives.

Finally, in our previous communications, we have suggested that the Agencies should carefully evaluate the market implications of a bifurcated capital approach for financial institutions. One of the key goals of the Basel capital reform process is to create a level competitive environment. We expressed our concern that establishing a regulatory framework that advantages or disadvantages large institutions over smaller institutions for certain asset classes would result in unintended consequences that could be detrimental to existing well-functioning market segments. In this regard, MICA is pleased that in the Basel IA proposal the Agencies are revising the existing risk-based capital requirements to address competitive equity questions that may arise through the U.S. implementation of the Basel II framework.

## Summary

MICA supports much of the Basel IA proposal as set forth in the ANPR as it relates to risk weighting of capital for residential mortgage risk. Our general comments are as follows:

1. We support the concept of basing risk weights on initial loan-to-value (LTV) ratios after consideration of private mortgage insurance. We agree that the current use of original LTV ratios by lenders makes their use for measuring risk sensitivity appropriate and easily done with minimal regulatory burden.
2. We recommend that the proposed regulation continue to make use of the concept of prudently underwritten loans as the standard for developing risk-based capital standards. In order to create clear and simple capital requirements that are still responsive to risk factors, we recommend that the Agencies classify mortgage loans as "standard" or "non-standard", according to the traditional definitions of prudential underwriting.
3. We believe that the use of economic capital estimates are the most appropriate method for setting appropriate risk weights by LTV. We recommend changes to the illustrative risk weights set forth in the ANPR to cover a wider spectrum of LTV ratios for standard and non-standard loans. The risk weights we propose were developed using MICA's long-run industry data base to compare its long-run average experience in both frequency of foreclosure and recovery value of foreclosed properties to those assumptions used by various rating agencies.
4. We concur that a separate set of risk weights be developed to cover the greater risk inherent in second lien mortgages. We view this risk as inherently similar to the subordinated interests of mortgage and asset-backed securities. Given the subordinated interests of second lien holders this means that the necessary risk weights should reflect the increased riskiness of such assets. We believe that because the volatility of the two liens is at least as great as that of a single lien, first and second lien risk weights must be set so that the combined required capital for the two loans be no different than if there were only a single loan with the same combined LTV (CLTV). Accordingly, MICA calculated the second lien risk weight levels that would be required for various combinations of first and second liens with a given CLTV (holding the first lien risk weights the same as other loans of the same LTV) to see what the average risk weight required for that CLTV combination would be. We set forth recommended risk weights for these loans based on this approach.

5. We recommend that pool mortgage insurance not be used to reduce LTV ratios for the purpose of determining capital requirements on a loan level basis.
6. We oppose the establishment of risk weight floors for insured non-standard products such as novel loans or exotic products since applying such a floor will create a disincentive for banks to acquire adequate third-party credit risk mitigation on these high risk loans. Risk weight floors will result in unnecessarily high losses for banks holding these loans.
7. We note that although credit score classifications have proven useful in distinguishing very low risk borrowers and very high risk borrowers from borrowers with average risk levels, the fact remains that the reliability of credit score classifications has yet to be tested during a period of significant economic stress. Consequently, we advise against the use of credit scores in determining appropriate capital requirements.
8. We do not believe that the capital requirement associated with a loan should be revised based on updated LTVs. Using historical performance data by US region we find that expected losses and loss severity are unaffected by general home price appreciation, unless such appreciation is substantially above long-run averages for a sustained period of time. We suggest that a more appropriate method for dealing with changes in risk over time would be to adjust capital based on loan age.
9. If the Agencies choose to expand the scope of recognized guarantors, MICA recommends they adhere to the Basel II International Guidelines covering the use of third party guarantors to reflect the risk associated with lower-rated credit risk mitigation providers.

### The Private Mortgage Insurance Industry

MI is a sound and sure form of credit risk mitigation (CRM) and distinctly different from other forms of insurance and CRM. The economics of the residential mortgage market and of the secondary mortgage market, the self-interest of private mortgage insurers and the nature of residential mortgage defaults have resulted in a system in which private mortgage insurers pay all valid claims in full and on a timely basis. The economic incentive continues for insurers to pay all valid claims in full to facilitate the continued use of this form of proven CRM by all participants in the primary and secondary mortgage markets.

Subsequent purchasers of mortgages with MI can rely on the MI company to meet its obligations even though the holder of the mortgage is often not the originator of the loan nor did it negotiate the terms of the insurance coverage. Moreover, the event that triggers the MI company's obligation to pay the holder of the mortgage is borrower default on the underlying mortgage -- an obligation that is clearly defined in all MI agreements and in courts of law as an obligation without legal ambiguity. Thus, when a financial institution holding a mortgage with MI makes a claim, the mortgage insurer pays it in a timely manner. There is none of the uncertainty or delay associated with surety bonds or other forms of corporate CRM, nor any of the contractual uncertainties associated with credit derivatives.

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

Thus, MI has several factors that clearly distinguish it from other forms of CRM:

- the amount of protection is firmly established at the initiation of the insurance policy and it is not subject to renegotiation or cancellation by the mortgage insurer;
- full rights related to MI are transferred with the underlying asset without any subsequent contractual negotiations that could reduce the value of the CRM;
- the point at which MI may be terminated is based solely on the current loan-to-value ratio, not on extraneous risk factors. Thus, there is no risk that the MI will be cancelled or compromised if a borrower's risk profile increases due to new factors (e.g., unemployment);
- the event that triggers MI and the amount paid are not subject to after-the-fact negotiation, except in cases in which a lender may have engaged in fraud, which does not undermine the value of this form of CRM. This is in sharp contrast to other forms of CRM, where post-claim negotiations and non-payment are common;
- by law, MIs generally are not allowed to invest premium revenues in single-family residential mortgage-related investments. In addition, rating agencies require portfolio diversification. Thus, during periods

of significant house price deflation the ability of the MI to pay its claims in full is not compromised by a double exposure to the health of the residential mortgage market. This allows MIs to serve as CRM protecting the lender from double default; and

- Mortgage insurers are subject to statutory contingency reserve requirements requiring retention of half the premium for 120 months, to be released earlier only in high loss years or as otherwise permitted under state laws. This ensures that profits are retained through good periods of the economic cycle for use in downturns.
- An array of recent regulatory statements properly reflect how reliably private MI absorbs mortgage credit risk. For example, international regulators have recently issued a variety of statements warning about credit risk transfer structures, but expressly favor reliance on regulated CRM like private MI. Further, U.S. regulators have expressly pointed to the important role of private MI in recent guidance on risky second liens (May, 2005) and proposed guidance on non-traditional mortgages (December 2005).

MICA believes that, for all of the above reasons, the proposed treatment of CRM benefit ascribed to the use of private mortgage insurance under Basel IA is fully justified. The proposed treatment appropriately reflects the mortgage insurance industry's record of reliably absorbing even catastrophic mortgage risk under unusually adverse conditions such as those in the Oil Patch and south Central regions during the 1980s and California and the Northeast in the late 1980s and early 1990s. Additionally, the residential mortgage market has justifiably expected that MIs will pay their claims in full and on a timely basis. The MI industry understands the needs of the mortgage markets for this type of CRM and has been providing it for decades.

#### Determining Loan Quality

MICA recommends that the proposed regulation continue to make use of the concept of prudently underwritten loans as the standard for developing risk-based capital standards. The mortgage lending industry has a long tradition in which prudential underwriting criteria have been well established. These criteria include:

- credit - the borrower has established the ability and willingness to repay debt in a timely manner;
- capacity - the borrower has sufficient income to make full principal and interest payments;
- collateral - the downpayment provides sufficient equity and the value of the property is sufficient to cover potential losses.

Traditionally, sufficient credit meant the borrower had a reasonably

extensive credit history with very few negative items. Sufficient income meant that the borrower had steady employment and would be spending no more than 28% of her income on her housing payments and no more than 36% on her total monthly debt obligations. Sufficient collateral meant at least a 20% down payment on a properly appraised home, with mortgage insurance acceptable as an alternative to the 20% down payment. In addition to these three "C's", standard underwriting guidelines traditionally required that the credit, income, assets, employment, and property value be fully documented and verified. Finally, in order to qualify as prudential lending, mortgage loans have traditionally been required to be fully amortizing over a reasonable period, no more than 30 years.

Over time, lenders, regulators, and investors have gradually pushed on these boundaries. Debt ratio limits were expanded for 15-year mortgages, for example, justified on the basis that the higher debt ratio risks were offset by accelerated development of borrower equity in a 15-year loan. Documentation requirements have been relaxed for borrowers with better perceived credit, for example, based on mortgage payment history and other factors. Property valuation standards have been relaxed for lower LTV ratios. Each of these decisions, on its own, may represent a prudent judgment about the offsetting nature of the risks involved. Collectively however, they have produced a significant expansion of what traditionally has been viewed as "prudent" mortgage lending.

Varying mortgage capital requirements by all of these factors will, of course, complicate the capital assessment process and run afoul of the Agencies' stated goal of balancing increased risk sensitivity with operational feasibility. The process of choosing factors and weights for them is data and resource-intensive. This is appropriate in the context of the Basel II IRB approach for the largest banks, but it would be far too cumbersome to serve as a universal model for all banks under the proposed regulation. MICA also notes that the incremental benefit of attempting to fine tune capital requirements with multiple dependent and independent factors may be limited as these same risk factors have already been incorporated into the pricing of the mortgage loan by the lender. Such pricing reflects expected loss, not the unexpected loss that is the focus of regulatory risk-based capital.

#### Standard and Non-Standard Loans for Basel IA

In order to create clear and simple capital requirements that are still responsive to risk factors, MICA recommends that the Agencies classify mortgage loans as "standard" or "non-standard", according to the traditional definitions of prudential underwriting:

- adequate credit, as measured by a credit report and accompanying credit scores;
- adequate capacity, as measured by employment information and debt ratios;

- adequate collateral, as measured by down payment and property valuation;
- loan products that positively amortize fully over a reasonable time with minimal payment shock potential; and
- full verification and documentation of all aspects of the underwriting criteria.

Any loan which meets all of the prudential underwriting criteria should be classified as "standard;" all others should be classified as "non-standard."

### Risk Weights and Initial LTV in Basel IA

MICA believes that varying risk weights to the initial LTV ratio of a residential mortgage loan is critical to assuring that prudential capital is required for institutions choosing to hold these loans. Since the beginning of the Basel II process, we have provided regulators with data showing the close link between initial LTV and both the frequency of default (probability of default) (PD) and the severity of losses (loss-given- default) (LGD) and we will be happy to re-supply this data to the Agencies.

MICA also believes that the use of economic capital estimates are the most appropriate method for setting appropriate risk weights by LTV. To clearly demonstrate the relative differences in economic capital by LTV, MICA utilized its industry data base to compare its long-run average experience in both frequency of foreclosure and recovery value of foreclosed properties to those assumptions used by various rating agencies. For fully documented, fixed rate, purchase loans on single-family detached homes utilizing full appraisals, MICA's long-run average data closely conforms to rating agencies' B-rating scenarios for loans with the same loan characteristics and average FICO scores. In addition, the MICA long-run average recovery value of foreclosed properties as a percentage of stated property value at the origination of the loan also matched well with rating agency assumptions for a B-rating.

For MICA's estimates of an appropriate set of stress assumptions, we compared the rating agency assumptions for each stress level higher than a single B until we reached a differential in losses (from the expected B-levels) that approximated the 35% risk weight on 80% LTV loans (considered to be prudently underwritten loans). Using the estimated economic capital for 80% LTV as a benchmark for the 35% risk weight for standard loans, MICA estimated risk weights for all other LTV groups by loan type. MICA also estimated economic capital when the initial LTV of the loan had been reduced to 65% LTV and 60% LTV. The results are presented in the tables below. (See Appendix A for details of the calculations.)



Risk Weights for Standard Loans

For prudently underwritten loans that meet the criteria noted above for “standard” loans, the risk weights for first liens with primary mortgage insurance coverage delivered by a AA-rated MI that brings the initial LTV of the loan down to an 80% LTV, 65% LTV or 60% LTV level would be as follows:

Table 1. Proposed Risk Weights (RWs) For Standard Loans

<u>Initial LTV</u>	<u>AA Rated MI-Insured Loans</u>			
	<u>Uninsured RWs</u>	<u>Coverage to 80% LTV RWs</u>	<u>Coverage to 65% LTV RWs</u>	<u>Coverage to 60% LTV RWs</u>
≤ 60	35%	NA	NA	NA
> 60 ≤ 70	35%	NA	20%	20%
> 70 ≤ 75	35%	NA	20%	20%
> 75 ≤ 80	35%	NA	20%	20%
> 80 ≤ 85	50%	35%	20%	20%
> 85 ≤ 90	75%	50%	35%	20%
> 90 ≤ 95	100%	75%	35%	20%
> 95 ≤ 97	125%	75%	35%	20%
> 97 ≤ 100	150%	100%	35%	35%

Risk Weights for Non -Standard Loans

For loans that do not meet the standard loan classification, the risk weights for first liens with primary mortgage insurance coverage delivered by a AA-rated MI that brings the initial LTV of the loan down to an 80% LTV, 65% LTV or 60% LTV level would be as follows:

Table 2. Proposed Risk Weights (RWs) For Non-Standard Loans

<u>Initial LTV</u>	<u>AA Rated MI-Insured Loans</u>			
	<u>Uninsured RWs</u>	<u>Coverage to 80% LTV RWs</u>	<u>Coverage to 65% LTV RWs</u>	<u>Coverage to 60% LTV RWs</u>
≤ 60	35%	NA	NA	NA
> 60 ≤ 70	35%	NA	20%	20%
> 70 ≤ 75	50%	NA	35%	20%
> 75 ≤ 80	75%	NA	35%	20%
> 80 ≤ 85	125%	100%	35%	20%
> 85 ≤ 90	175%	125%	50%	35%
> 90 ≤ 95	250%	150%	75%	50%
> 95 ≤ 97	275%	175%	75%	50%
> 97 ≤ 100	325%	200%	100%	75%

For a more detailed discussion of how the risk weights were determined for both standard and non-standard loans please see Appendix A.

### Piggyback Loans

The credit rating agencies recognize the greater risk associated with piggyback loans, noting that the absence of accumulated equity also restricts borrower ability to maintain or improve their home. They have observed that, when a default occurs, the loss severity will be higher.<sup>2</sup> Analysts have also begun to recognize that the layering of risk inherent in a piggyback loan with no borrower initial equity, high debt to income ratios and the possibility of an interest-only or other exotic first lien increases the overall risk to the holder of both parts of the piggyback mortgage.

Breaking a borrower's debt obligation into two separate loans creates several variations in both the PD and LGDs of both loans that are indeed tied to the CLTV of the two loans. For the holder of the junior lien, the expected LGD is generally quite high (nearly 100% when the companion first lien LTV equals 80 and the CLTV exceeds 80), because the second lien is in the first loss position. For the holder of the first lien, in the event of a default, the LGD is consistent with the LGDs of other first lien loans with the same LTV. MICA has also observed that second lien PD associated with a given CLTV is substantially higher than for a single loan first lien with an LTV equivalent to that CLTV. This holds true over a range of high values for CLTVs (over 80 CLTVs). (See Appendix B)

In addition, during the exceptionally benign economic conditions of the past several years, first lien performance of piggyback loan arrangements has been worse than that for single loan first liens with the same LTV. However, the default incidence of the first lien has not been as high as the default incidence for single loans with the same CLTV. (Observations were restricted to closed end seconds to maintain comparability with actual indebtedness.) Under more stressful economic conditions, MICA believes that the default frequency of first lien piggybacks will trend towards the default frequency for the single loan CLTV under the same stress. If so, then the volatility and the corresponding economic capital for first lien components of piggybacks would be higher than for "unitary" first liens of the same LTV (implying the possible appropriateness of a higher risk weight for the first lien when it is part of a piggyback than when it is issued alone).

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<sup>2</sup> "Glenn Costello, a managing director at Fitch Ratings, explained that since second lien borrowers have close to 100% LTV, the lack of accumulated equity therefore restricts their ability to maintain or improve their homes. Additionally, the loss severity is higher for second lien loans." As reported in Asset Securitization Report, August 8, 2005.

In reference to Table 3 below, MICA believes that because the partitioning of a mortgage transaction into two separable pieces cannot reduce (and may increase) the volatility of loss risk in the total transaction, the risk weights for the two loans must be set in a fashion that would have the combined required capital for the two loans be at least as large as for a single loan with the same CLTV. (And, if the two components are separately owned, their combined risk weights should typically exceed the risk weight for a unitary loan with LTV equal to their CLTV, absent a common servicing and default management arrangement). MICA calculated the second lien risk weight levels that would be required for various combinations of first and second liens with a given CLTV (holding the first lien risk weights the same as other loans of the same LTV) to see what the average risk weight required for that CLTV combination would be for this best case (no increase in total volatility) situation. Our results show that the required second lien risk weights would start at 35% for seconds with CLTVs of 80 or less and then rise dramatically as the CLTV increased. The results in Table 3 cover loans with CLTVs up to 100%. For loans with CLTVs above 100% the risk weight for the second lien should be that which apply for an unsecured and uninsured loan.

**Table 3: Second Lien Risk Weights Required To Equate Two Loan Total Capital To Single Loan Capital Of Similar CLTV**

First Lien LTV	CLTV 100			CLTV 95			CLTV 90		
	2nd Lien LTV	First Lien RW	2nd Lien RW	2nd Lien LTV	First Lien RW	2nd Lien RW	2nd Lien LTV	First Lien RW	2nd Lien RW
55	45	35%	235%	40	35%	189%	35	35%	138%
60	40	35%	260%	35	35%	211%	30	35%	155%
65	35	35%	292%	30	35%	241%	25	35%	179%
70	30	35%	335%	25	35%	282%	20	35%	215%
75	25	35%	395%	20	35%	344%	15	35%	275%
80	20	35%	485%	15	35%	447%	10	35%	395%
85	15	50%	550%	10	50%	525%	5	50%	500%
90	10	75%	575%	5	75%	550%			

  

First Lien LTV	CLTV 85			CLTV 80		
	2nd Lien LTV	First Lien RW	2nd Lien RW	2nd Lien LTV	First Lien RW	2nd Lien RW
55	30	35%	78%	25	35%	35%
60	25	35%	86%	20	35%	35%
65	20	35%	99%	15	35%	35%
70	15	35%	120%	10	35%	35%
75	10	35%	163%	5	35%	35%
80	5	35%	290%			

Shaded Second Lien Risk Weights Indicate Those Second Lien Risk Weights Of Less Than 100%

For non-standard piggyback loans, the risk weight would have to reflect the higher risk inherent in both the first and second liens. For these non-standard loans MICA recommends that the risk weights essentially be doubled for each of the above categories. If a second lien is fully covered by mortgage insurance (i.e., the third party insurance covers 100% of the second lien amount), then the risk weight for the insured loan should reflect the rating of the insurer as is the case for first liens with private mortgage insurance coverage. The requirement that the third party insurance cover 100% of the second lien amount reflects the 100% LGD that can be expected on these loans.

### Role of Pool Insurance

The Agencies also seek comment on whether loan-level or portfolio MI should be used to reduce LTV ratios for the purposes of determining capital requirements. With regard to portfolio MI, MICA recommends that such coverage should not be used to reduce LTV ratios for the purpose of determining capital requirements. Portfolio, or pool insurance, has many different structures that involve different levels of coinsurance and aggregate loss limitation. For example, a typical pool structure might have a deductible amount paid by the lender, above which the insurer covers all losses until they reach the aggregate limit. Beyond the aggregate limit, the lender is again responsible for all losses. Thus, while some loans may effectively be covered to 100% of their exposure by pool insurance, other loans effectively have no coverage. For these reasons it is impossible to translate portfolio coverage into a loan-level effective LTV estimate. To the extent it gives a benefit based on external ratings, pool insurance could result in a reduction of risk based capital for the mortgage pool as a whole, but not a reduction in risk-weights for the individual loans. Dispersion of risk resulting from the use of pool insurance from a AA or better rated mortgage insurer should be a positive factor considered by examiners and external raters of mortgage pools.

### Risk-Weight Floors for High Risk Insured Mortgages

The Agencies seek comment on whether risk-weight floors are appropriate for certain insured mortgages, especially higher-risk loans and novel products. Applying a risk-weight floor to MI-insured loans will create a disincentive for banks and savings associations to acquire third party credit risk mitigation on these high risk loans and unnecessarily limits the capital relief benefit available to institutions seeking to manage their mortgage credit risk exposures. In fact, it is critical that capital rules create the greatest incentives for CRM use precisely for higher-risk and novel products, as institutions should make the most use of MI and other sound forms of CRM when they are most unsure about the long-term performance of such products.

In our previous comment letters, MICA has presented data that estimated the average loss-given-default (LGD) to insured mortgage holders after benefit of MI

payments. That data reflected the distributions of net salvage values incurred over the 1990-2003 period assuming industry-standard MI coverage levels. The analysis showed that generally the average net LGD *after* MI ranged between 4.6% and 7.6%.

The problem with proposing any risk-weight floor on MI insured loans is that it would discourage lenders from utilizing deeper MI coverage that could have the effect of bringing lender's net LGDs to zero. This is especially important with respect to high-risk nonstandard or "exotic" loans as noted in the ANPR. Limiting the risk weight benefits of acquiring credit risk mitigation runs directly counter to the goals of enhancing the risk sensitivity of the existing risk-based capital framework as set forth in the ANPR. For this reason we do not believe a risk weight floor should be implemented.

#### Assessment Mechanisms Combining Initial LTV with Other Factors

The Agencies seek comment on the use of an assessment mechanism based on LTV ratios in combination with credit assessments, debt-to-income ratios or other relevant measures of credit quality. MICA notes that these stated criteria are currently reflected in both the underwriting process undertaken by the lender in determining whether to originate the loan --and, accordingly, in the lender's pricing of that loan -- as well as in the process used by the mortgage insurer in determining whether to insure it. In the tables provided above, we have accounted for varying credit risk factors by setting separate risk weights for non-standard as distinct from standard mortgages.

#### Credit Scores and Lower Income Borrowers

The Agencies seek comment on the impact of the use of credit scores on the availability of credit or prices for lower-income borrowers. Credit scores were developed in the late 1980s and early 1990s, and became more widespread after 1995. While credit score classifications apparently have proven useful in distinguishing very low risk borrowers and very high risk borrowers from borrowers with average risk levels, the fact remains that the reliability of credit score classifications has yet to be tested during a period of significant economic stress. As a consequence, there is insufficient actual loan performance experience to be certain that the relative performance differences by score observed under the very good economic conditions of the past ten years will hold up under more stressful conditions. Even among the rating agencies, whose job it is to quantify how bad loan performance might be for pools of loans forming a mortgage-backed security, significant differences of opinion exist as to the performance of loans by credit score for particular LTV groups under stress conditions.

MICA believes that the accuracy of credit scores in determining PD will not be fully tested until the U.S. again experiences a period of significant regional economic stress (as occurred in the Oil Patch states in the mid-1980s and in

Southern California and the northeast states in the early 1990s), and so we advise against the use of credit scores in determining appropriate capital requirements.

### Updated Assessments of LTV and Other Factors

While it is certainly desirable to update the LTV of a mortgaged property for internal-control purposes, the use of market appreciation information to update LTV for capital calculations would be inappropriate. MICA has observed that, except in those unusual cases where house prices have increased substantially above long-run average rates for a significant period of time, there is no appreciable decline in the expected foreclosures from the remaining loans as LTVs decrease due to house price appreciation. In addition, a review of the average percentage recovery of original value on the sale of foreclosed properties over the life of a particular cohort of loans by origination year and location also does not appear to be affected by general changes in local market home values over time, unless of course the general appreciation rate is substantially above long-run averages. This implies that despite increases in the general market value of underlying collateral, the expected LGD of loans that will foreclose after such normal appreciation does not get lower. That is not to say that LGD is not related to current LTV, however. The data strongly suggest that the loans that are most likely to go to foreclosure are on properties that have not been maintained or for some other reason have not participated in the general rise in home values. Consequently, any regulatory policy that would permit adjustments to the LTV due to normal market appreciation will understate the need for economic capital on older loans.

Marking property values to market also would introduce substantial risk of exacerbating housing cycles. The recent significant increases in house prices, especially in coastal markets, would cause decreases in capital requirements, encouraging further lending, which would create additional upward pressure on prices. It would also deplete capital just when it is needed most - to prepare for the potential drop in house prices that many economists view as inevitable. If prices drop, banks would be forced to add capital, causing them to reduce their lending activity, putting additional downward pressure on house prices. Such mark-to-market capital regulations clearly would be a destabilizing factor to the banking and housing industries.

A more appropriate method for dealing with changes in risk over time would be to adjust capital based on loan age. MICA's experience with mortgage credit risk over time is that older loans generally show less variance from expected loss performance. The benefit of older loans is not that these loans perform better, but rather that they are less prone to be negatively influenced by pronounced changes in the economy. In other words, unseasoned loans have shown a greater volatility in response to negative economic situations than seasoned loans. Rather than spending a great deal of time and resources on estimating how underlying property values may have changed, MICA believes that the use of seasoning

factors is more efficient and more transparent for bank planning and management. MICA proposes the following seasoning factors to be used on all residential risk segments:

Table 4: Recommended Risk Weight Factors by Loan Age

<u>Age of Loan</u>	<u>Seasoning Factor</u>
≤ 4 Years	100%
> 4 ≤ 7 Years	75 %
> 7 ≤ 10 Years	50 %
>10 Years	25 %

#### Expanding the Scope of Guarantors

The Agencies seek comment on expanding the scope of recognized guarantors to include "any entity whose long-term senior debt has been assigned an external debt rating of at least investment grade by an NRSRO". It is also suggested that, should first loss coverage protection reduce the effective net LTV to less than 60%, the effective risk weight conferred would be 20%, provided the rating of the guarantor is equivalent to an investment grade or equivalent rating (based on senior long-term debt).

Our concerns with this approach are two fold. First it suggests that the risk of default on the benefits of a AA claims paying rated counterparty is the equivalent of risk of default on benefits provided by a non-insurance provider with a senior long-term debt rating of A. Second, unlike the Basel II proposal, this approach does not take into consideration the significant higher risk of a lower-rated guarantor's failure to perform.

Even though an MI company with a AA claims paying rating has the same senior long-term debt rating as the non-insurance A-rated company, its claims paying ability is higher. This is because any guarantee issued by a non-insurance A-rated company will be lumped together with the claims of all unsecured creditors in the event of insolvency. However, for an MI company, all debt is subordinated to the interests of the policyholders under state insolvency laws. Consequently, there is materially less risk that MI policyholders will not be paid as compared to the risk associated with a normal corporate guarantee. If the Agencies choose to expand the scope of guarantors they should consider this important difference between claims paying ability and general debt rating.

Also, to better reflect the risk associated with lower rated credit risk providers, MICA recommends that for Basel IA, the U.S. regulators adhere to the Basel II standardized guidelines covering the use of third party guarantors. Those guidelines state that the resulting risk weights applied to assets supported by complete (100% coverage) guarantees from third parties rated A or higher shall

substitute the rating of the provider as follows: 20% risk weights for guarantees from AAA- or AA-rated guarantors and 50% risk weights for A- rated guarantors. The Basel II risk-weights appear to reflect the relative default rates under stress and the relative risk of downgrade for the guarantors. More explanation of this risk is set forth in Appendix C. MICA urges the Agencies to limit eligible guarantors to A or higher rated entities, and to require that the benefit of such credit risk mitigation result in risk weights no lower than those as prescribed by the standardized Basel II guidelines for third-party guarantors.

### Conclusion

MICA is very supportive of the work done by each of the Agencies as reflected in the Basel IA proposal. We believe that our recommendations, which are based on our industry's decades of experience in insuring low downpayment residential mortgages, support the Agencies' goal of enhancing the risk sensitivity of the existing risk-based capital framework.

MICA would be pleased to discuss with any of the U.S. banking regulators the points raised in this comment letter at your convenience.

Sincerely,

Suzanne C. Hutchinson



## **Appendix A**

### **Economic Capital Calculations for Standard Loans**

Economic capital is generally defined as the difference between VaR (stress losses) and expected losses, also known as “unexpected losses”. It assumes that in the case of mortgage loans, the interest spreads are generally sufficient to cover all costs and expected losses. Capital is therefore required to cover those situations in which losses are in excess of expectations and to ensure that there are funds sufficient to cover all obligations. While the Basel II formulas used in setting IRB capital levels are based on annual average PDs and stress level LGDs, MICA prefers to go by what it knows best – residential loan losses. Credit risk on residential mortgage loans is a long-term exposure. Both regulatory and rating agency MI capital requirements are generally based on ten-year stress models. But while our capital perspective is taken from a slightly different view than described by Basel II, MICA believes that the relative credit risk exposures as estimated in this section are very exacting.

As stated in the main body of our comment letter, MICA believes that segmentation by loan type and LTV are the most appropriate means of viewing residential mortgage risk. To clearly isolate the impact of LTV, the analysis that follows utilizes an MI industry data set that is comprised solely of fixed rate, fully documented, owner occupied, purchase loans for single-family detached homes by LTV on loans originated from 1971 through 2001. Our analysis also takes into consideration the assumption sets utilized by rating agencies in setting levels of credit enhancement required for various tranches of rated mortgage backed securities. The analysis also utilizes a special industry data compilation of recovery values of foreclosed properties from 1990 through 2003 to calculate average LGD by LTV as well as the average benefit of both industry-standard MI coverage and deeper coverage MI policies.

Based on available FICO information on MI insured loans, we find that the long-run average insured high LTV loan has an average FICO score of approximately 680 to 700. In comparing long-run average performance data by original LTV to rating agency assumptions for foreclosure frequency on 680 FICO loans by LTV for various rating scenario levels ( AAA, AA, A, BBB, etc. ) , MICA finds that the “B” sets of assumptions best approximates MI industry average performance. Consequently, for purposes of our analysis, expected losses are based on Fitch-IBCA assumptions for 680 FICO scores.

For unexpected losses, our analysis must choose a stress level that is consistent with Basel II expectations that “prudentially underwritten” loans carry a risk weight of 35%. The Basel Committee elaborated further on this to say that such loans would involve a significant degree of over-collateralization of the underlying collateral. U.S. regulators have suggested that a fully documented 80% LTV loan generally fits this description. MICA’s methodology in setting the appropriate stress level for unexpected losses is to review the differences in losses

by rating scenario relative to “B” assumptions for 80 LTV loans in order to determine which scenario yields an economic capital estimate that is less than or equal to 35% of 8% or 2.8% . Using “BBB” assumptions, the economic capital would be only 1.33% -- too low; using “AA” assumptions, the estimates are 3.29% -- too high. So the best fit is roughly an “A” scenario for unexpected losses, which yields an economic capital level of 2.34%.

In Table A1 below, MICA shows the levels of both expected and unexpected losses by LTV and the estimated economic capital for standard conventional, fully underwritten and documented loans (and assuming FICO scores greater than 640).

Table A1: Uninsured Standard Loan Economic Capital Estimates

LTV Range	Expected Loss			VaR (Stress Loss)			Economic Capital	Relative RW	Proposed RW
	Freq.	LGD	Loss	Freq.	LGD	Loss			
≤ 60	0.7%	3.1%	0.02%	3.4%	13.6%	0.46%	0.44%	6.6%	35%
> 60 ≤ 70	1.0%	8.3%	0.08%	4.9%	23.5%	1.15%	1.07%	16.0%	35%
> 70 ≤ 75	1.3%	12.1%	0.16%	6.1%	28.5%	1.74%	1.58%	23.7%	35%
> 75 ≤ 80	1.8%	16.3%	0.29%	7.9%	33.3%	2.63%	2.34%	35.0%	35%
> 80 ≤ 85	2.5%	20.7%	0.52%	10.4%	37.8%	3.93%	3.41%	51.0%	50%
> 85 ≤ 90	3.6%	25.2%	0.91%	14.0%	41.9%	5.87%	4.96%	74.2%	75%
> 90 ≤ 95	5.1%	29.5%	1.50%	18.9%	45.6%	8.62%	7.12%	106.5%	100%
> 95 ≤ 97	6.2%	31.1%	1.93%	22.2%	47.0%	10.42%	8.49%	126.9%	125%
97 ≤ 100	7.3%	33.5%	2.45%	25.4%	49.0%	12.45%	10.00%	149.6%	150%

In keeping with the general rule that individual country regulators have the authority to create rules that are more conservative than the proposed international standards, but not to set standards that are less conservative, MICA believes that uninsured loans of 80 LTV or less should not carry risk weights that are lower than the proposed 35%.

#### Proposed Risk Weights For Insured Standard Loans

MICA believes that in order to set appropriate risk weights for insured loans the insights gained through the estimates of economic capital developed above are also useful in examining the benefits of MI assuming current industry-standard coverage levels.

But before outlining our economic capital estimates for insured loans, MICA believes it is helpful for regulators to clearly understand how MI benefits are calculated. Industry-standard MI policy coverage levels generally vary by LTV class. MI policies generally provide that a claim payment will be equal to the lesser of the following: 1) the loan amount outstanding plus unpaid interest from time of foreclosure to settlement of claim plus foreclosure costs, plus real estate taxes incurred over the same time frame (which altogether is considered the “Claim Amount”) less the recovery value of the property, or 2) the coverage percentage times the Claim Amount. The MI will also work with the lender and the borrower prior to foreclosure find ways to either mitigate the loss to all parties through a pre-foreclosure sale which may or may not cover all losses, or to assist in the formation of a work-out plan that could restore the borrower’s financial situation and keep the borrower in the home. For all of the above reasons, there is a distribution of possible loss outcomes that shifts depending on the prevailing economic situation in the market and it is possible that, in certain economic scenarios, the MI claims payment will not make a lender whole on a given loan.

MICA’s estimates of LGD in the case of uninsured loans utilized this same concept in estimating the losses in both the expected and unexpected loss cases, except that for the stress case the distribution of recovery values was shifted in order to effect a lower average recovery value consistent with Fitch assumptions for an “A” scenario. In table A2 below, MICA shows its estimates of LGD as net of MI benefits where such benefits are based on the industry-standard MI coverage levels as specified by LTV.

Table A2: Estimates of Economic Capital for Insured Standard Loans

LTV	Coverage	Expected Loss			VaR (Stress Loss)			Economic Capital	Relative RW	Proposed RW
		Freq.	LGD	Loss	Freq.	LGD	Loss			
85	12%	2.5%	9.0%	0.23%	10.4%	22.8%	2.40%	2.14%	32.0%	35%
90	25%	3.6%	3.8%	0.14%	14.0%	13.3%	1.90%	1.73%	25.8%	35%
95	30%	5.1%	2.6%	0.18%	18.9%	12.6%	2.40%	2.20%	32.9%	35%
100	35%	6.2%	2.5%	0.15%	22.2%	9.9%	2.20%	2.04%	30.5%	35%

In the ANPR for Basel 1A, U.S .regulators suggest that if a third party guaranty on the original loan amount less the coverage percentage put the net coverage level below 60% LTV, that such a loan might be eligible for a 20% risk weight regardless of the rating of the guarantor. As discussed in the main body of our comment letter, MICA strongly recommends that U.S. regulators adhere to the Basel II standardized guidelines covering the use of third party guarantors. Consequently, only coverage from guarantors or MI companies with ratings of

AA- or higher should be able to provide benefits sufficient to lower the regulatory capital to such a low level. Under Basel II, benefits from “A” rated guarantors can only lower risk weights to 50%. And as shown above, even benefits from “AA” rated companies using industry-standard coverage levels can only result in an insured risk weight of around 30-35%. However, if lenders were to purchase deeper coverage levels, such coverage levels could result in economic capital estimates that are indeed consistent with 20% risk weights. While our deeper coverage examples have been rounded upward, it is clear that U.S. regulators were on track by approximating coverages that put the “net loan” (the original LTV percentage less the coverage percentage) at just below 60. Such coverage will indeed produce insured loan economic capital estimates consistent with a 20% risk weight. (See table A3 below.)

Table A3: Estimates of Economic Capital for Insured Standard Loans

LTV	Coverage	Expected Loss			VaR (Stress Loss)			Economic Capital	Relative RW	Proposed RW
		Freq.	LGD	Loss	Freq.	LGD	Loss			
85	25%	2.5%	2.2%	0.06%	10.4%	9.6%	1.00%	0.95%	14.1%	20%
90	30%	3.6%	2.1%	0.08%	14.0%	9.1%	1.37%	1.20%	17.9%	20%
95	40%	5.1%	1.0%	0.05%	18.9%	5.4%	1.00%	0.97%	14.6%	20%
100	45%	6.2%	1.3%	0.08%	22.2%	6.5%	1.40%	1.35%	20.2%	20%

Economic Capital Estimates for Non-Standard Loans

The analysis above was intended strictly for prudently underwritten, fully documented loans with FICO scores greater than 640. MICA would collectively aggregate all other first lien loans under a “non-standard” classification. Estimates of economic capital for non-standard loans would use rating agency assumptions by LTV for “B” and “A” scenarios as the average of results for loans with FICO scores between 600 and 640. Our LGD estimates will be higher than those for standard loans because of the higher interest rates charged on these riskier assets. In Table A4, MICA displays the elements that make up our estimates of economic capital and the ensuing risk weights for uninsured non-standard loans.

Table A4: Uninsured Non-Standard Loan Economic Capital Estimates

LTV Range	Expected Loss			VaR (Stress Loss)			Economic Capital	Relative RW	Proposed RW
	Freq.	LGD	Loss	Freq.	LGD	Loss			
≤ 60	1.3%	3.5%	0.04%	5.9%	14.6%	0.86%	0.81%	12%	50%
> 60 ≤ 70	2.4%	9.1%	0.22%	10.0%	24.7%	2.47%	2.26%	34%	50%
> 70 ≤ 75	3.4%	13.0%	0.44%	13.3%	29.9%	3.97%	3.53%	53%	50%
> 75 ≤ 80	4.8%	17.4%	0.84%	18.0%	34.8%	6.26%	5.42%	81%	75%
> 80 ≤ 85	6.9%	22.0%	1.52%	24.3%	39.3%	9.55%	8.03%	120%	125%
> 85 ≤ 90	9.8%	26.6%	2.60%	32.4%	43.4%	4.10%	11.45%	171%	175%
> 90 ≤ 95	13.5%	30.9%	4.17%	42.5%	47.1%	20.00%	15.85%	237%	250%
> 95 ≤ 100	15.8%	32.6%	5.16%	48.5%	48.5%	23.50%	18.34%	274%	275%
>100	18.2%	35.0%	6.37%	54.4%	50.5%	27.50%	21.11%	316%	325%

MICA believes that uninsured non-standard loans should have a minimum risk weight that reflects the differential between economic capital and the prudently underwritten Basel II standard approach risk weight of 35%. Consequently, MICA proposes a risk weight floor of 50% for uninsured non-standard first lien mortgages.

MI can significantly reduce the amount of economic capital required for non-standard loans. In the Table A5, MICA presents the net economic capital levels associated with various levels of MI coverage. For each of the LTV categories, the coverage is expressed in terms of coverage down to a particular LTV level. The corresponding percentage of coverage is derived by taking the difference between the original LTV and the “coverage down to level” divided by the original LTV. For example : for an 80% LTV loan with coverage down to 65%, the comparable coverage percentage would be 18.75%, while for a 95% LTV loan such coverage to 65% would imply a coverage percentage of 31.6%.

Table A5: Estimates of Insured Non-Standard Economic Capital by Coverage Levels

LTV Range	Coverage to 65				Coverage to 60				Coverage To 55			
	“A”	“B”	EC	RW	“A”	“B”	EC	RW	“A”	B”	EC	RW
> 60 ≤ 70	1.7	0.12	1.60%	24%	1.1	0.06	1.00%	15%	0.5	0.02	0.44%	7%
> 70 ≤ 75	2.0	0.14	1.90%	28%	1.2	0.07	1.20%	17%	0.5	0.02	0.49%	7%
> 75 ≤ 80	2.4	0.17	2.20%	33%	1.4	0.08	1.40%	20%	0.6	0.02	0.55%	8%
> 80 ≤ 85	2.8	0.20	2.60%	39%	1.7	0.09	1.60%	24%	0.7	0.03	0.63%	9%
> 85 ≤ 90	3.8	0.30	3.50%	52%	2.3	0.15	2.20%	33%	1.0	0.05	0.94%	14%
> 90 ≤ 95	5.1	0.45	4.60%	69%	3.3	0.23	3.10%	46%	1.5	0.08	1.44%	22%
> 95 ≤ 100	5.9	0.55	5.40%	80%	4.0	0.29	3.70%	55%	2.1	0.12	2.00%	30%

Note: In Table A5, table numbers listed as “A” and “B” represent the net residual losses after MI benefits for that particular LTV under unexpected and expected loss scenarios. “EC” equals the economic capital for that segment. RW is the calculated risk weight relative to the economic capital of a standard 80 LTV loan.

Table A5 demonstrates that MI coverage on non-standard loans needs to be deeper than the standard levels now in the market. Coverage to 60% LTV will allow for risk weights of 35% or less on loans up to 90 LTV, with 50% coverage on loans over 90 LTV. Coverage to 55 LTV would produce risk weights of 20% on most LTV groups from about 94% LTV and below. With this coverage loans above 94% LTV and up to 100% LTV should require risk weights of only 35%.

## **Appendix B**

### **Calculation of Economic Capital for Second Liens**

MICA has discussed the problem of inadequate capital requirements on second liens with high CLTVs in past comment letters to U.S. banking regulators. Our thoughts on the subject have not changed. In our opinion, under the current capital regulations, the calculation of capital requirements for second liens without regard to CLTV allows banks to game the system with regard to high risk residential lending. MICA strongly believes that the amount of capital held for two loans issued against a single residential property should not be lower than the capital required for a single loan with the same total amount of indebtedness. In case of separate ownership and default management, it may be appropriate for it to be higher.

The “piggyback”, a mortgage secured transaction which has separable loan components, one with a first lien and the other with a second lien on the same collateral, presents a credit risk which equals or exceeds the credit risk of a unitary first lien loan of the same total amount. The correlation of the default performance of the components, though always positive, can be less than 100%, especially if held by distinct investors, so the sum of the volatilities of the components will at least equal, but may exceed, the volatility of the unitary transaction. Thus the economic capital required for the two components will at least equal and, in the absence of unitary default management, will typically exceed the economic capital required for the unitary transaction.

In cases where the second lien is more volatile than the first lien, due to the much higher PD on the second and moderate volatility of severity on the first, and because the second lien is subordinate to the interests of the first lien holder (causing the second lien holder to bear the brunt of the potential loss for the two combined loans in the event of a default), the risk weight assigned to the second lien not only needs to be substantially higher, it needs to be high enough so that the capital assigned to both loans equals at least the amount of capital required of a single loan with the same degree of indebtedness.

In theory, the smaller the size of the second lien relative to the overall CLTV the larger the correct risk weight needs to be. However, in the event that the risk weight for a second lien implied by these conditions exceeded the risk weight for an otherwise equivalent but unsecured retail loan, an appropriate adjustment could be made to keep the combined risk weight of the two components equal to the risk weight for the corresponding single loan. This adjustment would be to increase the risk weight of the corresponding first lien component to offset the reduction in the second lien risk weight required to bring it into line with the appropriate risk weight for the comparable unsecured loan.

In the ANPR issued in July of 2003, U.S. regulators sought comment on proposed ABS risk weights on multi-tranched security exposures. For the portions

of subordinated tranches rated BBB- and below, the proposed risk weights ranged from 100% for BBB- to 650% for BB-, with all other lower rated and unrated tranches requiring a deduction from capital held. (See Table B1 below taken from page 135 of the ANPR.)

**Table B1 : ABS Risk Weights Based On Long-Term Credit Assessments**

<b><u>External Rating</u></b>	<b><u>Base Case</u></b>	<b><u>Non-Granular Pools</u></b>
AAA	12%	20%
AA	15%	25%
A	20%	35%
BBB+	50%	50%
BBB	75%	75%
BBB-	100%	100%
BB+	250%	250%
BB	425%	425%
BB-	650%	650%
Below BB-	Deduction	Deduction

Assuming that the first lien risk weights by LTV are correct, and for the moment supposing that the first lien of a two loan exposure should retain a risk weight equal to other first liens of the same LTV (not CLTV), we can then calculate the level of capital required to equate the total amount needed and the appropriate risk weight needed for the second lien. MICA's resulting risk weights by lien size within given CLTV categories are displayed in Table B2 below:



**Table B2 : Second Lien Risk Weights Required**

**To Equate Two Loan Total Capital To Single Loan Capital Of Similar CLTV**

	CLTV 100					CLTV 95				CLTV 90				
	2cnd	First	2cnd	Single	Standard	2cnd	First	2cnd	Single	2cnd	First	2cnd	Single	
	Lien	Lien	Lien	Lien		Lien	Lien	Lien	Lien	Lien	Lien	Lien	Lien	Standard
LTV	RW	RW	RW	RW	LTV	RW	RW	RW	LTV	RW	RW	RW		
<b>55</b>	45	35%	235%	125		40	35%	189%		95	35	35%	138%	67.5
<b>60</b>	40	35%	260%	125		35	35%	211%		95	30	35%	155%	67.5
<b>65</b>	35	35%	292%	125		30	35%	241%		95	25	35%	179%	67.5
<b>70</b>	30	35%	335%	125		25	35%	282%		95	20	35%	215%	67.5
<b>75</b>	25	35%	395%	125		20	35%	344%		95	15	35%	275%	67.5
<b>80</b>	20	35%	485%	125		15	35%	447%		95	10	35%	395%	67.5
<b>85</b>	15	<b>50%</b>	550%	125		10	<b>50%</b>	525%		95	5	<b>50%</b>	500%	67.5
<b>90</b>	10	<b>75%</b>	575%	125		5	<b>75%</b>	550%		95				

	CLTV 85					CLTV 80			
	2cnd	First	2cnd	Single	Standard	2cnd	First	2cnd	Single
	Lien	Lien	Lien	Lien		Lien	Lien	Lien	Lien
LTV	RW	RW	RW	RW	LTV	RW	RW	RW	
<b>55</b>	30	35%	<b>78%</b>	42.5		25	35%	<b>35%</b>	28
<b>60</b>	25	35%	<b>86%</b>	42.5		20	35%	<b>35%</b>	28
<b>65</b>	20	35%	<b>99%</b>	42.5		15	35%	<b>35%</b>	28
<b>70</b>	15	35%	120%	42.5		10	35%	<b>35%</b>	28
<b>75</b>	10	35%	163%	42.5		5	35%	<b>35%</b>	28
<b>80</b>	5	35%	290%	42.5					

**Shaded Second Lien Risk Weights Indicate Those Second Lien Risk Weights Of Less Than 100%**

MICA notes that there are several possible second lien segments that should require less than 100% risk weights – indeed all second liens associated with CLTVs of 80 or less should qualify for a 35% risk weight. However as one moves up the CLTV scale and/or moves down the size of the second relative to the overall CLTV, the risk weight needed to equate total capital held to the same level of indebtedness requires sharply higher risk weights that are indeed consistent with the subordinated tranche ABS risk weights already proposed.

MICA would expect that some banks will attempt to counter MICA's position by offering up their own performance data on piggyback loans in an attempt to argue that such structures have actually out-performed other single loans with LTVs equal to the piggyback's CLTV. However, we believe that this is often not a fair comparison because, piggyback loans are frequently comprised of a first lien coupled with a HELOC second that either is never utilized or is only partially utilized, so that the actual CLTV is significantly lower than the potential CLTV. In the single loan, the borrower has incurred the full amount of the debt exposure and must endure the heavier monthly debt payment burden, and the loan performance will reflect that higher LTV. But a loan that has the mere potential to have an equally high CLTV but actually has a lower one would of course be expected to perform better. Therefore, the only fair comparisons are between piggyback arrangements with closed-end seconds and their single loan counterparts.

## **Appendix C**

### **Comparative Risks Associated with Guarantors by NRSRO Ratings**

The Basel II standardized guidelines covering the use of third party guarantors apply the rating of the provider when setting the risk weights for assets supported by complete (100% coverage) guarantees from third parties rated A or higher. This translates to 20% risk weights for guarantees from AAA- or AA-rated guarantors and 50% risk weights for A- rated guarantors. The difference in the suggested risk weights appears to be directly related to relative default rates under stress conditions where A-rated entities defaulted at 2.4 times the frequency of entities rated AA or higher (i.e., 20% times 2.4 equals 48%). The relative risk of downgrade to levels below A are an important consideration in determining appropriate capital risk weight since the probability of downgrade within a one year period to less than an A rating is 16.9 times higher for A-rated companies than for AA- or higher rated entities.

The ANPR suggests that risk weights on residential mortgage loans with initial net LTVs below 60% will be set at 20% regardless of the rating of the guarantor whose credit enhancement has been relied upon to reduce the risk associated with the initial LTV of the mortgage. This generous treatment implies that there is no difference in the risk assessment of benefits to be derived from guarantors as long as they are rated BBB3, BBB- or higher. Presumably, if the rating of the guarantor falls below the minimum investment grade rating, the capital risk weights would have to revert to those applicable to uninsured loans, requiring an institution holding the loans to increase its capital for all of its exposures to the lower-rated guarantor. This would expose banks and savings associations to potentially significant capital hikes during economic downturns, especially in light of the large percentages of total assets which mortgages pose for many insured depositories. A capital increase at this point of the economic cycle would be “pro-cyclical” – that is, it would worsen the overall economy by creating a strong disincentive for institutions to continue making mortgage loans.

Comparing average one-year transitions of ratings from 1983 through 2002, we observe that the risk of a BBB-rated guarantor falling to below investment grade is 5.6 times higher than for an A-rated guarantor and 40.2 times greater than guarantors rated AA or higher.<sup>3</sup> Under stress, BBB-rated guarantors had default rates that were 2.44 times worse than A-rated guarantors and 5.13 times worse than that of entities rated AA or higher. During periods of economic stress, the probability of such downward revisions increases markedly and, given the circumstances, the loss of coverage may not be easily replaced by other firms providing credit risk mitigation.

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<sup>3</sup> Source for Issuer Performance Ratings referenced above is "Default & Recovery Rates of Corporate Bond Issuers", Moody's Investors Service, February 2003.