Insurance Company

307 North Michigan Avenue, Chicago, Illinois 60601-5382, 312/346-8100

March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2006-49

Re: Risk-Based Capital Guidelines;
Capital Adequacy Guidelines;
Capital Maintenance: Domestic Capital Modifications

OCC:	Docket Number 06-15; RIN 1557-AC95
Board:	Docket No. R-1238
FDIC:	RIN 3064-AC96
OTS:	No. 2006-49; RIN 1550-AB98

Ladies and Gentlemen:

Old Republic Insurance Company ("ORINSCO") appreciates the opportunity to comment on the Basel IA NPR issued by the Office

of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies").

In collaboration with United Guaranty Residential Insurance Company of North Carolina, ORINSCO has prepared a white paper entitled "Portfolio Credit Indemnity Insurance: A Strong Form of Credit Risk Mitigation that Warrants Regulatory Recognition." The white paper provides background information on portfolio credit indemnity insurance, which has been available for more than 50 years, and respectfully recommends that the Agencies recognize the value of this coverage in making risk-based capital determination. The white paper submitted herewith is also included in today's submission of United Guaranty Residential Insurance Company of North Carolina under separate cover.

ORINSCO is prepared to answer any questions the Agencies may have about this white paper specifically or about portfolio credit indemnity insurance generally. Please direct your questions to:

John R. Heitkamp, Jr., Deputy General Counsel
Old Republic Insurance Company
307 North Michigan Avenue
Chicago, Illinois 60601
Tel.: 312.762.4209

Once again, ORINSCO thanks the Agencies for the opportunity to comment on the proposed regulations.

Very truly yours,

James A. Kellogg
President

Encl.

cc: John R. Heitkamp, Jr.

Office of the Comptroller of the Currency - 3-27-07

PORTFOLIO CREDIT INDEMNITY INSURANCE:

A Strong Form of Credit Risk Mitigation that Warrants Regulatory Recognition

A white paper submitted on behalf of

United Guaranty Residential Insurance Company of North Carolina
a subsidiary of American International Group, Inc.

and

Old Republic Insurance Company
a subsidiary of Old Republic International Corporation

March 26, 2007

Recognition of Insurance on Junior Lien Residential Mortgage Loans

The Agencies acknowledge the value of insurance on both first lien mortgage loans and junior lien loans in determining a lender's capital requirements and refer to such insurance in each case as private mortgage insurance ("PMI"). The proposed regulations recognize the significant risk mitigating impact of PMI and, therefore, take PMI into account in calculating the loan-to-value ratios for risk-based capital determinations. Among the qualifications for recognition is that the insurance be underwritten by a mortgage insurer. Unfortunately, this qualification conflicts with the insurance regulatory framework that governs PMI.

Under state insurance laws and regulations, PMI is almost universally defined as insurance on first lien mortgage loans only and provided by a designated monoline insurer of that product.

Portfolio credit indemnity insurance (PCII) provides risk mitigation for junior lien loans that is substantially similar to PMI, which is understood to refer exclusively to insurance on first-lien mortgage loans. We respectfully submit that PCII should be credited as well in calculating loan-to-value ratios on insured junior lien loans.

In this paper, United Guaranty Residential Insurance Company of North Carolina (UGC) and Old Republic Insurance Company (ORINSCO) present an overview of portfolio credit indemnity insurance, a form of credit risk mitigation with increasing market demand due to lender interest in meeting consumer borrowing needs. We think it essential for bank and savings association regulators to understand this product and the regulatory framework in which it operates, so they can evaluate the manner in which it should be recognized in any future credit risk management and capital rules, as well as the current rewrite of the Basel Capital Accord.

UGC has provided this type of insurance security since 1970, while ORINSCO has done so since 1954, when it first entered the field with a private sector answer to FHA's Title I program.

Both firms are regulated by the insurance departments of the various states, are members of major insurance families, and are highly rated by well-known independent rating agencies:

UGC	A+	A.M. Best	ORINSCO	A+
UGC	AA	Moody's	ORINSCO	Aa2
UGC	AA	Standard & Poor's	ORINSCO	AA

Key Characteristics of Portfolio Credit Indemnity Insurance

- A proven form of credit risk mitigation (CRM) provided by regulated insurance firms with the capital and ratings to ensure commitments are honored.
- A well-regulated form of CRM without the operational and legal risk identified by international regulators, with credit derivatives and certain other forms of credit risk transfer.
- A demonstrated way for banks and savings associations to address credit risk not anticipated at consumer loan origination.

Appropriate regulatory recognition includes the following:

- Clarification of the second-lien guidance to make clear that PCII is an acceptable form of CRM for risk concentrations in addition to the private mortgage insurance and pool mortgage insurance specifically mentioned in the guidance.[1]
- An indication in subsequent Basel II guidance to make clear that PCII is an acceptable form of CRM that permits reduced risk-based capital
- Recognition of PCII in the pending Basel IA rewrite to ensure that it is a recognized form of CRM.

In this paper, UGC and ORINSCO are pleased to:

- Describe PCII as a product
- Detail the PCII regulatory and ratings framework
- Describe specified appropriate regulatory recognition in light of these product and regulatory characteristics.

We are prepared to answer any questions this paper raises and provide additional information as needed.

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[1] *Credit Risk Management Guidance for Home Equity Lending*, Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, and National Credit Union Administration, May 16, 2005.

Portfolio Credit Indemnity Insurance Basics

Several companies have insurance affiliates that provide separately mortgage guaranty insurance coverage on a portfolio basis, which ensures that lenders can manage credit risks on (1) loans they may or may not have originated and (2) on other consumer loans that have exhibited certain risk characteristics over time. Such consumer loans include home improvement loans, home equity and junior lien loans, and debt consolidation loans. PCII has been successfully distributed for more than 50 years, during which time it has proven that it can safely be applied to various consumer loans other than traditional mortgages. Accordingly, portfolios containing home equity, boat, automobile, and student loans can all benefit from risk mitigation provided by PCII. While the PCII market is not as developed as the mortgage guaranty one, PCII is a well established product. The overall market for this product is obviously much larger, potentially including many facets of consumer lending, such as junior lien loans.

PCII is a proven risk mitigant that does not present many of the dangers of other forms of portfolio insurance (such as dynamic hedging) or credit derivatives. Unlike PCII, these other forms of insurance or CRM can actually subject firms to greater risk. It is for this reason that the International Joint Forum recently completed a detailed consultative effort on credit risk transfer (CRT) with an array of new internal risk-management and supervisory standards designed to limit counterparty credit, operational, and liquidity risk in the credit derivatives arena.[2]

How PCII Works

PCII insures the lender against the risk of default on loans. The portfolio can be structured as a pool of previously originated loans (or lines of credit) or on a flow basis (loans or lines meeting mutually agreed-upon underwriting criteria originated during a 12 month period). Coverage remains in effect on a covered loan until the loan is paid in full, sold, or transferred by the insured lender.

Premiums are typically expressed as a rate in basis points charged against the outstanding balance of the insured loans. As the outstanding balance declines over time, the premium for continued coverage on those loans also declines.

PCII covers a loss caused by the borrower's failure to make payment on an insured loan. Various coverage options are offered and may be up to as much as 100% of the insured loan's unpaid principal and accumulated interest. The PCII insurer pays the loss in return for an assignment of the lender's interest in the insured loan, including any recovery rights. Recovery rights are those associated with the value of the foreclosed property securing the loan.

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[2] *Credit Risk Transfer,* Basel Committee on Bank Supervision, Joint Forum, March 2005.

PCII may pay a lender's covered loss for amounts that exceed a predetermined loan to value ratio and would not require an assignment of the lender's interest in the insured loan. In this coverage structure, the similarities between PCII and traditional PMI are patent, with the chief difference being the former covers a junior loan and the latter covers a first lien mortgage loan. However, unlike the case with PMI where only 20 - 40% of first-liens are lost upon default, most insureds elect 100% coverage of junior liens since normally 75% -100% of the loan amount is lost in a default.

Cumulative payments on the overall portfolio are, however, subject to a stop loss limit. The stop loss is expressed as a percentage (usually 10%) of either the original aggregate principal balances for closed-end loans or the original aggregate lines of credit extended for the portfolio. As noted above, the portfolio can be structured as a collection of previously originated loans (or lines of credit) or on a flow basis (by loans or lines meeting mutually agreed-upon underwriting criteria insured during a 12 month period). By agreement with the lender, the stop-loss limit can also be enhanced through supplemental loan-level insurance coverage.

When a PCII insurer contracts with a lender, the insurer develops a policy tailored to fit state regulations that clearly lays out the settlement process. The usual claims process requires the insured party to notify the provider of the default. Claims are paid within 60 days of receipt of all appropriate documentation.

Importantly, PCII insurers commonly do not require the lender to foreclose on insured loans as a prerequisite for collection. This enables lenders to mitigate their loss without undertaking costly and often time-consuming foreclosure and recovery proceedings, which frequently yield little, if any, salvage.

Events triggering PCII agreements result in an obligation that is clearly defined in courts of law. Accordingly, the amount of protection is firmly established when the insurance policy is initiated; full rights are transferred with the underlying asset and without any subsequent contractual negotiations. Also, the amounts paid under PCII are not subject to after-the-fact negotiation, except in cases where fraudulent activity may have occurred.

PCII Regulatory Framework

PCII is a product offered solely by state-regulated, licensed insurers. They are subject to on-going scrutiny by both domiciliary insurance regulators and the regulators of those states in which they are authorized to underwrite this coverage. They must meet the applicable capital and surplus requirements and are continuously monitored by state regulators to ensure solvency.

In addition, PCII insurers establish loan-loss reserve levels that are carefully developed and reviewed by licensed actuaries. This is done by taking into account the asset type, length of the claim cycle, and other well-established actuarial methods. Reserves are then reviewed periodically by both internal and independent actuaries to ensure safety

and soundness. PCII insurers also frequently purchase reinsurance to cover various unforeseen events that might be outside methodology or assumptions.

Most states also require prior regulatory approval of the PCII insurance policy form and the premium rates that are charged lenders.

PCII Insurer Affiliates & Ratings

PCII insurers generally operate as affiliates of multiple-lines property and casualty insurers and mortgage insurers. All significant PCII insurers are AA-rated (or better) for their claims-paying ability by credit ratings agencies using rigorous stress tests covering the claims-paying ability of the insurer over a significantly longer period than the one-year holding period used in the Basel internal ratings standards.

PCII insurers' ratings are generally derived from their strong capital position and experience/business expertise, as well as any implicit support derived from their parent. As previously noted, UGC is currently rated AA by both Moody's and Standard & Poor's. ORINSCO's claims paying ability is rated Aa2 by Moody's, and AA by both Fitch and Standard & Poor's.

Relation of PCII to Regulatory and Capital Initiatives

Second-Lien Guidance

UGC and ORINSCO appreciate the reference to private and pool mortgage insurance in its interagency guidance on risky second mortgage liens. However, we would suggest that it be clarified to add PCII as an approved form of CRM for risk concentrations. As released, the only forms of CRM expressly named are private and pool MI, with the guidance suggesting that "other" forms of CRM may also be used. This would encompass PCII, but also many other forms of CRM. As noted, international regulators have highlighted a range of potentially serious risks with these forms of credit risk mitigation/transfer. These include:

- Credit risk, because the counterparty in the CRT transaction may not be able to honor the commitment. Even if it is a funded commitment, concentration in the CRT market makes it vulnerable to contagion credit risk

- Liquidity risk, because the concentrated number of providers make it possible that an unanticipated event will dry up the market and leave lenders with unanticipated credit risk

- Operational risk, because systems have yet to handle CRT volume

- Legal risk, based on the fact that non-PCII portfolio insurance products may not have the legal settlement certainty detailed above for PCII.

Basel II

UGC and ORINSCO are pleased that the final Accord promulgated last year by the Basel Committee[3], the U.S. banking agencies' 2003 advance notice of proposed rulemaking[4], and the proposed Basel II U.S. retail and mortgage-loan guidance,[5] all provide a clear framework for CRM recognition. PCII meets the criteria for CRM in all of these standards because, as noted above, it is a robust and highly-rated form of CRM. We would suggest that the U.S. agencies clarify this in future Basel standards by detailing the types of CRM eligible for recognition.

We understand that the U.S. rules, like the international ones, have yet to finalize the way double-default protection in CRM is addressed under Basel II.[6] Earlier this year, the Basel Committee proposed a way to handle the double-default value of CRM – that is, the fact that it is highly unlikely that a CRM provider will default at the same time a claim it has backed defaults – further enhancing the value of CRM. As noted above, MI is not highly correlated with mortgage risk because of the way in which it is regulated. Thus, PCII is similarly not correlated and should be granted any double-default recognition afforded to retail CRM in the Basel or U.S. standards.

Basel IA

Finally, we urge the U.S. regulators to follow the approach to CRM in Basel II in the proposed revisions to the risk-based capital rules for institutions that may not wish (or be able) to qualify for Basel II. Failure to do so will create an opportunity for regulatory arbitrage, specifically, for institutions to take high-risk positions because their risk-based capital does not fully reflect such risk. CRM is a simple attribute of credit risk management that can be easily adopted into the revised capital rules for smaller institutions, and doing so would create an appropriate regulatory capital incentive for prudent credit risk management.

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[3] *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Bank for International Settlement, Basel Committee, June 2004.
[4] *Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*, Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, August 4, 2003.
[5] *Internal Ratings-Based System for Retail Credit Risk for Regulatory Capital,* Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, and Department of the Treasury, October 27, 2004.
[6] *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects,* Bank for International Settlement, Basel Committee and International Organization of Securities Commissions, April 11, 2005.