Mortgage Insurance Companies of America

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Office of the Comptroller of the Currency
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Mail Stop 2-3
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Docket ID OCC-2010-0003

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R–[1401]

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

Ladies and Gentlemen:

The Mortgage Insurance Companies of America ("MICA") is pleased to comment on the notice of proposed rulemaking ("NPR" or "proposal") submitted for public comment by your agencies related to alternative measures of credit risk that can be used in place of reliance on ratings provided by nationally-recognized statistical ratings organizations ("NRSROs") and credit rating agencies ("CRAs").[1] MICA understands that, while this NPR expressly addresses ratings replacements in the pending rewrite to the market-risk rules proposed by the agencies to implement the "Basel II.5" regulations,[2] we note the agencies' expressed intent also to adapt the final approach approved in

[1] Office of Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, *Notice of Proposed Rulemaking Regarding Alternatives to Use of Credit Ratings for Debt and Securitization Positions*, 76 Fed. Reg. 79380 (Dec. 21, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-12-21/pdf/2011-32073.pdf.

[2] Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, *Notice of Proposed Rulemaking Regarding Risk-Based Capital Guidelines: Market Risk*, 76 Fed. Reg. 1890 (Jan. 11, 2011), *available at* http://edocket.access.gpo.gov/2011/pdf/2010-32189.pdf.

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this context for use in the broader framework of regulatory-capital regulation for U.S. insured depositories and holding companies. MICA supports a system of credit-risk determinations for regulatory purposes that is as consistent as possible across the full range of applicable U.S. rules, and we thus here provide comments applicable to the overall framework of regulatory-capital regulation, as well as to specific issues raised in this NPR germane to residential-mortgage finance.

In general, MICA commends the agencies for recognizing that trading-book exposures are not just subject to market risk (i.e., fluctuations in market demand due to equity-price considerations), but also to credit risk resulting from underlying credit risk at issuers or assets in asset-backed securities ("ABS"). The Basel II.5 rules concluded by global regulators[3] are a significant improvement in this regard, and we welcome the additional efforts now under way to conform trading- and banking-book risk-based capital to ensure that credit risk is consistently captured wherever it arises in a banking organization. Doing so will significantly improve the safety and soundness of banking organizations as well as make more difficult the "arbitraging" of risk between the banking and trading books that exacerbated the global financial crisis. However, as discussed in more detail below, we believe the agencies' express goal of finding as simple and transparent as possible a replacement for ratings can be achieved in part by reliance on proven forms of credit risk mitigation ("CRM") provided by capitalized, unaffiliated CRM providers. When capital is placed at risk ahead of a bank's trading or banking book, there is no opportunity for arbitrage, investors and regulators can quickly identify strengths and weaknesses in overall credit risk, and correlation risk within a banking organization is dramatically reduced. Further, reliance on third-party CRM from regulated, unaffiliated firms would reduce systemic inter-connectedness.

MICA has long worked with the Board of Governors of the Federal Reserve ("FRB"), Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), and Securities and Exchange Commission ("SEC") as alternatives to CRAs have been assessed, including providing an in-depth response to the inter-agency advance notice of proposed rulemaking ("ANPR") by the banking agencies seeking views on broad options for replacing ratings in risk-based capital regulation.[4] Throughout these comments, we have

[3] Basel Committee on Banking Supervision (BCBS), *Revisions to the Basel II Market Risk Framework* (Feb. 2011), *available at* http://www.bis.org/publ/bcbs193.pdf.

[4] *See* MICA, comment on *Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, 75 Fed. Reg. 52,283 (August 25, 2010), *available at* http://www.regulations.gov/#!documentDetail;D=OCC-2010-0016-0012; and comment on *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 74 Fed. Reg. 52,374 (Oct. 9, 2009), *available at* http://www.sec.gov/comments/s7-17-08/s71708-24.pdf; and comment on *References to*

urged the agencies to replace CRAs with simple and transparent credit-risk criteria that can be readily used by banking organizations of all sizes that are readily validated by senior management, boards of directors, examiners and investors. Among these criteria is the degree to which a credit-risk exposure (including those related to the trading book) is protected by credit enhancement provided by a regulated, capitalized, unaffiliated third party such as a provider of private mortgage insurance ("MI").

In our prior comment letters, MICA has provided extensive discussion as to why reliance on true third parties reduces correlation risk within both a banking organization and the financial system. This is because risk can be effectively laid off, instead of being absorbed at the same time assets without CRM are also under stress. Further, MI is generally provided at the loan level, providing transparent, first-loss risk protection over the life of the loan (except to the degree that required statutory cancellation provisions are triggered).[5] In sharp contrast, credit enhancements in the wholesale arena (e.g., credit default swaps) are of course almost always provided by large banking organizations and thus may pose correlation and systemic risk of their own. Indeed, they of course did so throughout the financial crisis.

We note that regulators may now be coming to recognize the value of CRM in the retail sector. FRB Governor Duke has recently suggested that the current system of loan classifications designed to capture increased credit risk should be revised.[6] Specifically, Ms. Duke argued that the current regulatory system should be revised to reflect not just the probability of default ("PD"), but also loss given default ("LGD"). LGD reductions, she rightly said, arise when a loan exposure is supported either by collateral or credit enhancement. This is true not just for loan classifications, but also for other regulatory judgments of credit risk, including those related to risk-based capital weightings.
Based on these principles, MICA is pleased respectfully to offer the following comments to the agencies on this NPR:

- We urge clarified treatment of mortgage-backed securities ("MBS") guaranteed by the government-sponsored enterprises ("GSEs") to conform the capital rules to the treatment proposed for GSEs in the FRB's pending

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Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg., 40088 (July 11, 2008), *available at* http://www.sec.gov/comments/s7-17-08/s71708-8.pdf.

[5] Homeowners Protection Act of 1998, Pub. L. No. 105-206, 112 Stat. 897 (1998).
[6] Elizabeth Duke, *Opportunities to Reduce Regulatory Burden and Improve Credit Availability* (Jan. 13, 2012), http://www.federalreserve.gov/newsevents/speech/duke20120113a.htm.

systemic-risk regulations.[7] For as long as Fannie Mae and Freddie Mac are in conservatorship, all of their non-equity obligations, not just debt, should be treated as agency obligations with preferential risk weightings. Indeed, given the "effective" guarantee Treasury Secretary Geithner says now protects these obligations,[8] parallel treatment is warranted for GSEs obligations with comparable ones of the U.S. Government "USG"). Parallel treatment would create a strong incentive for the return of private capital to the residential-mortgage market without posing any real risk to banking organizations.

- MICA supports the proposed treatment for structured ABS, which in part relies on a "look-through" to the capital treatment of the underlying asset under the current "general" capital requirements applicable to U.S. banking organizations.[9] We also support the revised weightings related to tranches in structured ABS which rightly capture the credit risk resulting from financial engineering.

- We urge comparable risk weightings for the corporate obligations of regulated financial organizations subject to prudential and capital requirements to those proposed for insured depositories, foreign banks and credit unions. MICA believes the regulatory framework for these firms is robust and that there is no clear rationale for discriminating between banks and certain other financial firms (e.g., bank holding companies, state-regulated insurance companies). Indeed, we would note that the entire framework for financial regulation established in Title I of the Dodd-Frank Act[10] is premised on ensuring parallel prudential regulation for financial institutions, not continued favored treatment for banking organizations. This is, in part, because any such undue recognition for banks promotes market expectations that they remain "too big to fail."

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[7] Federal Reserve System, *Proposed Rule Regarding Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies* 77 Fed. Reg. 594 (Jan. 5, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

[8] Treasury Secretary Timothy Geithner, *testimony before the House Financial Services Committee* (Mar. 1, 2011), *available at* http://financialservices.house.gov/media/pdf/030111geithner.pdf. (stating that "[t]he Administration is fully committed to ensuring Fannie Mae and Freddie Mac have sufficient capital to perform under any guarantees issued now or in the future, as well as the ability to meet any of their debt obligations.")

[9] 12 CFR part 3, Appendix A (OCC); 12 CFR part 208, Appendix A and 12 CFR part 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

I. Treatment of GSE Obligations

In this NPR, the treatment of MBS guaranteed by Fannie Mae and Freddie Mac is not clearly addressed. The NPR does provide preferential capital treatment for the GSEs' debt obligations for as long as they retain their current structure (corporations chartered by Congress to serve express purposes without an explicit USG guarantee). Specific capital for market-risk purposes would range from 0.25 percent to 1.6 percent (assuming adequate capitalization of eight percent against risk-weighted assets).

The NPR does not make clear how this capital treatment would apply to GSE obligations that are not clear debt positions other than equity obligations and we urge the agencies to do so in their final rule to ensure efficient, transparent and prudent markets in this critical asset category.

Key here is the risk-based capital that would apply to MBS guaranteed for principal and interest without tranching by the GSEs. If treated as GSE debt obligations under the proposed treatment for debt issued by the GSEs, then a favorable capital treatment would continue to apply to these GSE-guaranteed MBS (with the treatment for structured ABS discussed below presumably applying to any comparable GSE MBS). If, however, GSE-guaranteed MBS that are straightforward guarantees are not treated as debt obligations specific to the GSEs, but instead are treated as generic corporate obligations, then the overall eight percent (100 percent weighting) for financial institutions would apply. This would increase current risk-based capital for GSE by five times, moving from the current twenty percent risk weighting up to the noted 100 percent.

Any such capital requirement would be wholly disproportionate to actual GSE credit risk given the effective USG guarantee for agency MBS noted above and would also cause a major disruption in the still-fragile U.S. residential-mortgage market by sharply reducing the ability of banking organizations to hold GSE MBS. This capital treatment would also heighten prudential risk by creating a capital penalty for holding GSE MBS for hedging purposes. As the agencies know well, these obligations are major components of current hedging positions, especially with regard to interest-rate risk. So high a capital charge would also adversely affect the ability of banking organizations to hold GSE MBS for purposes of meeting the pending Basel III liquidity rules.[11]

[11] BCBS, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 16,

Based on this, MICA urges the agencies to clarify that any GSE-issued MBS that does not meet the structuring provisions applicable to other asset-backed securities (see below) is considered equivalent to a GSE debt obligation and is similarly weighted.

II. ABS Regulatory Capital

As noted, MICA supports look-through to the underlying regulatory capital applicable to assets underlying ABS. Current U.S. "general" capital requirements,[12] as well as the Basel II risk weightings likely to be applied in the U.S. under the Basel III rules, rightly recognize the value of capitalized credit-risk mitigation.

We also commend the stringent nature of the proposed treatment for structured ABS, including MBS. MICA long alerted regulators to the hazards of structured MBS, including in connection with the above-referenced concern about reliance on CRAs, for example by warning regulators that the CRAs put undue faith in the value of financial engineering over actual capital at risk. We thus commend provisions in this NPR that require strict risk weightings for structured positions and look-through to ongoing risk and losses in the assets underlying ABS. Initial ratings at issuance proved a very poor predictor of real credit risk for MBS and, thus, the NPR's ongoing risk valuation for assets underlying ABS will prove a significant improvement over prior regulation.

Use of credit enhancement and recognition in the risk weightings will, as proposed, enhance regulatory-capital transparency because banks will need only to know if or if not capitalized credit enhancement like MI is in place. If it is, then losses are reduced and weightings can approximately reflect this. If not, then loss projections are considerably higher in default and risk weightings should be higher, and, perhaps punitively so for high-risk MBS structures that rely on cash-flow factors like "excess spread."

III. Corporate Debt

As noted, the NPR would significantly revise the treatment of corporate debt issued by "financial institutions" for purposes of the market-risk rules, replacing the current ratings-based methodology with a simple eight percent capital requirement (or 100 percent risk weighting). This approach is simpler than the "indicator-based"

2010), available at http://www.bis.org/publ/bcbs188.pdf.

[12] *See supra* note 10.

approach proposed for non-financial companies that are publicly-traded, but still far less favorable than the capital treatment proposed for insured depositories, foreign banks and credit unions. This would range from 0.25 to 12 percent based on the sovereign capital applicable to a home jurisdiction and the remaining maturity of the position, and be a range of 0.25 percent to 1.6 percent for U.S. entities.

MICA members fall under the definition of "financial institution" for purposes of the corporate debt treatment by virtue of their sole focus on mortgage insurance and related regulated insurance activities.[13] They thus would not be subject to the more complex indicator-based methodology for other corporate obligations, but still subjected to a capital disparity vis-à-vis depository institutions that may adversely affect capital-raising activities in the debt market.

We do not understand the distinction between different types of financial institutions included in the NPR that appears based more on type of activity than on actual regulation (including the degree to which a firm is governed for prudential and/or capital purposes). Indeed, some entities provided favorable risk weightings engage in high-risk activities (e.g., foreign banks that, while perhaps housed in a sovereign rated as low risk under the system elsewhere proposed in the NPR[14] due to the overall sovereign-debt risk perspective, reside in jurisdictions with lax prudential supervision and engage in high-risk activities). MI companies in the United States, in contrast are regulated with regard to capital, reserves, liquidity, permissible investments and other activities by regulators in each of the states in which they do business.

Thus, we urge the agencies to conform the treatment for appropriately-regulated financial companies (including parents of private mortgage insurers) to a capital regime applied to all regulated firms that provides equivalent risk weightings to those applicable to insured depositories, foreign banks and credit unions. Doing so would eliminate an incentive for banks to trade in obligations or hold those issued by high-risk banks, creating instead a capital incentive driven by risk in the financial sector as determined by industry regulations. To achieve this treatment, the agencies may wish to refine the definition of "financial institution" provided in the NPR to tighten the list of firms covered by a preferential risk weighting, moving other firms active in finance that do not meet appropriate regulatory standards into the capital standards proposed for publicly-traded non-financial corporate obligations. The NPR makes clear that the agencies plan to review the proposed, simple risk-based capital treatment included for financial-

[13] *See supra* note 1, at 79389.
[14] *See supra* note 1, at 79400.

institution corporate debt, but we urge the agencies not to finalize this rule until such treatment is determined and no undue disparity is created for debt obligations of regulated entities engaged in financial activities.

Conclusion

MICA is pleased to provide the agencies with our views on this important proposal and stand ready to provide any additional information of assistance as you finalize this proposal to advance the important goal of developing alternative criteria for regulatory judgment of credit risk. As discussed, we believe one way to achieve Congress' intent – an end to reliance on CRAs – is to reflect the credit-risk reductions obtained when regulated, capitalized CRM is provided. Doing so would, in fact, not only enhance credit-risk prudential regulation and incentives, but also reduce correlation risk and inter-connectedness because banks would obtain CRM from unaffiliated entities, many of them not likely to be designated as systemically-important financial institutions.

Sincerely,

Suzanne C. Hutchinson