Mortgage Insurance Companies of America

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Manager
Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Docket No. 2000-15

RE: Joint Notice of Proposed Rulemaking: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is responding to the notice of proposed rulemaking dated March 8, 2000, issued by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) to revise their respective risk-based capital treatment of recourse obligations and direct credit substitutes (DCS) that expose banks, bank holding companies, and thrifts (collectively banking organizations) to credit risk.

MICA is the trade association of the private mortgage insurance industry and, as such, represents those companies that provide insurance against losses from mortgage defaults for loan originators and the secondary market agencies. Our industry is required by its state regulators to hold a substantial capital base against risk. This capital has adequately protected both the mortgage insurers (MIs) and those we insure during times of risk in volatile mortgage markets.

MICA's comments on this latest proposal on recourse and direct credit substitutes should be read as an extension of our earlier comments to the Agencies on this same topic filed on February 2,

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1998. Additionally, MICA has filed comments on related risk-based capital issues with the Office of Federal Housing Enterprise Oversight (OFHEO) on March 10 and April 14, 2000, as well as with the Basle Committee Secretariat on March 21, 2000. We have taken a position in all of these letters that consistently emphasizes MICA's commitment to regulatory capital that, to the greatest degree possible, reflects economic risk.

Executive Summary

MICA's comments on the agency's recourse regulation are as follows:

- We strongly support the proposed treatment of subordinated loans, on which we commented in 1998. We urge clarification that all subordinated mortgage liens are recourse, regardless of whether or not they are part of a structured transaction. We continue to support the proposed treatment of spread accounts as recourse.
- Credit derivative positions maintained by banks in their own structured financings should be considered recourse.
- The ratings requirements should be strengthened so that banks cannot shop for better ratings.
- The capital requirement for positions rated BBB or lower should be increased to reflect the significantly higher probability of default.

The Rule Correctly Treats Subordinated Interests as Recourse

In 1998, MICA urged the regulators to ensure that the final recourse rule did not permit banking organizations to structure loans in ways that escape capital requirements appropriate for their economic risk. We noted in particular the proposed treatment of subordinated liens, which are increasingly common in mortgage lending.

First, many lenders now offer structured loans (e.g., 80-10-10s) that split loans into different tranches to avoid the need for appropriate credit enhancement when these loans are sold to

government-sponsored enterprises. The second lien in such purchase-money loans is a high-risk mortgage, as recognized in the agencies revised treatment for determining the loan-to-value ratio in such structured mortgages.

In our 1998 comment letter, MICA urged the agencies to implement the then-proposed treatment of subordinated positions in mortgage loans as recourse. The new proposal continues this approach, and we again strongly support it. Second liens in mortgage lending, whether originated at the same time as the first lien or placed subsequently on a home, are loans subordinated to the first lien and thus disproportionately risky extensions of credit. Treating subordinated mortgage liens as recourse is essential to ensuring that adequate capital backs this higher risk.

Treating subordinated mortgage liens as recourse not only accurately captures their economic risk in regulatory capital, but also creates a positive incentive for risk mitigation. Under the proposed ratings-based approach, recourse positions would bear capital based on their ratings. Thus, banks could obtain credit enhancement, including mortgage insurance, to reduce the capital cost of such high-risk positions. This is consistent with the larger intent of the recourse regulation and promotes safety and soundness.

We also applaud the regulators for continuing the proposed treatment for spread accounts and over-collateralizations as recourse or DCS. The asset quality of a spread account or over-collateralization can disappear overnight for even the most prudent mortgage underwriters. Often, spread accounts and over-collateralizations are vehicles not only for direct, but also for implicit, recourse. We urge the agencies to ensure that the final rules recognize the implicit-recourse potential of these instruments and that bank examiners be instructed in ways to review agreement terms or market practice to detect them.

The current proposal differs from the 1997 one by permitting banks to obtain improved weightings for nontraded positions even if no position in an instrument is traded. As long as subordinated

interests are deemed recourse, as proposed, MICA supports this revision. This is consistent with the longer-term direction of bank regulatory policy, which would recognize ratings for whole loans, as well as securitized positions. It is essential, however, that the agencies maintain the proposed discipline of requiring two ratings, public disclosure and the other safeguards for providing capital relief to nontraded positions to ensure that any capital relief is justified by the level of credit enhancement.

Retained Credit Derivatives Should Be considered Recourse

The agencies have asked for comment on the treatment of derivative positions retained by banks in loan structurings. As proposed, the recourse rule would treat credit derivatives as recourse when, as with other positions, they represent a commitment by the bank to absorb loss. MICA supports this treatment, which is consistent with the overall thrust of the recourse regulation. Failing to consider credit derivatives as recourse would create a major loophole in the regulation that would encourage banks to take undue risk. We would further note that credit derivatives remain a largely untested segment of the derivatives market with considerable legal uncertainty. Therefore, the conservative approach recommended in the proposal is appropriate and should be adopted in the final regulation.

Ratings Gaming Should Be Prevented

The recourse regulation, like the larger rewrite of the risk-based capital rules pending in the Basle committee, is intended to limit the ability of banks to game capital regulations to take more risk than is accurately captured in the capital requirements. The proposal is a significant advance over the current system, which permits considerable regulatory arbitrage. We strongly support, for example, the new focus on implicit recourse, which will capture in the capital requirements numerous risky arrangements now common in the market place. However, we believe the proposed rule still leaves certain opportunities for capital arbitrage because of ambiguities in the ratings approach and, as noted

below, a failure properly to reflect the real risk of lower-rated positions.

The proposal would permit banking organizations to seek a new rating when the rating on a traded position slips. This would permit banks to, in essence, shop for the best rating when circumstances turn against them. The Basle committee has noted the importance of maintaining integrity in the ratings-based approach to bank capital. Permitting banks to receive a "second opinion" from another agency would undermine the integrity of the ratings approach proposed in the recourse rule.

Low-Rated Positions Should Have Higher Capital

The proposal would impose a 100% risk weight on BBB-rated positions and a 200% weight on those with BB ratings. However, historical evidence indicates that the risk differential between BBB and BB-rated positions is far higher. In MICA's comments to OFHEO on the GSE risk-based capital proposal, we noted studies by both Standard & Poors and Moody's that demonstrated that default rates in below investment-grade rating categories are exponentially higher than investment-grade category default rates. The increase is particularly severe between the BBB and BB categories.

The S&P study[1] showed average cumulative fifteen-year default rates as follows:

AAA	1.06%
AA	1.11%
A	2.3%
BBB	4.21%
BB	16.75%
B	28.43%
CCC	42.72%

The Moody's study of average cumulative fifteen-year default rates for corporate bonds shows a 4.1% default rate for investment grade

[1] Standard and Poor's (1999) Property/Casualty Insurance Rating Criteria, page 9.

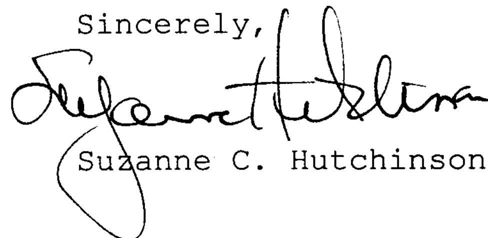
bonds and a 36.7% rate for "speculative" grade bonds.[2]

Given these data, the proposed increase from the 100% risk weighting for BBB to 200% weighting for BB is too low. To address this anomaly, the regulators should begin the gross-up treatment at the BB level instead of the B rating proposed. The gross-up method would, as proposed, impose the current low-recourse rule on these lower-rated instruments, which appropriately captures their higher risk.

Any failure by the final recourse rule accurately to capture the real risks associated with low-rated or unrated positions will create a perverse incentive for banks to obtain the least amount of risk mitigation possible. Treating BB-rated positions more favorably than default experience supports would encourage banks to use lower-rated credit enhancement because of the capital reward for doing so. This is contrary to the supervisory need to create incentives for banks to acquire the most, not the least, amount of credit risk mitigation possible.

We would be pleased to answer any questions you may have.

Sincerely,



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[2] Moody's Investor Service (January, 1999) Historical Default Rates of Corporate Bond Issues 1920-1998, Exhibit 31, page 26.