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May 14, 2001

**Mortgage  
Insurance  
Companies  
of America**

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1700 G Street, NW  
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Attention Docket No. 2001-~~13~~.<sup>14</sup>

Dear Sir or Madam:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on proposed changes to the capital treatment of high loan-to-value (LTV) mortgages. MICA is the trade association for the nation's private mortgage insurers. As such, we have a strong interest in how the regulators treat high-LTV mortgages, as well as decades of experience with the risks presented by such loans.

MICA believes that:

- OTS should not increase the LTV threshold for mortgages considered "prudent;" and
- OTS should follow the precedent set by other regulators and not allow other forms of credit enhancement to enable high-LTV loans to qualify for favorable capital treatment as "prudent" mortgages.

**I. Change to LTV Threshold**

MICA understands that the proposed LTV increase would bring OTS practice into harmony with that of the other bank regulators. However, we still urge caution. Savings associations tend to have far higher concentrations of mortgage

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loans than the commercial banks covered by the other regulators. Indeed, such a concentration of mortgages and mortgage-related assets is required for treatment as a "qualified thrift lender." Thus, changes in the capital required to back high-risk, high-LTV mortgages would have a disproportionate impact on thrift institutions. There is no concentration-related capital charge associated with this risk on savings association books, but this would be warranted if OTS otherwise liberalizes the capital requirements associated with high-risk, high-LTV mortgages.

We would note that Congress has expressly proscribed an LTV threshold at which credit enhancement is required for other institutions with high concentrations of mortgage assets. We refer to the requirement at 12 U.S.C. 1717 and 12 U.S.C. 1453, respectively, which mandate that Fannie Mae and Freddie Mac obtain bona-fide third-party credit enhancement when mortgages with LTVs above 80% are purchased. We urge OTS to be guided by this expression of Congressional intent and retain the 80% LTV threshold for savings associations.

## **II. Alternative Credit Enhancements**

We also urge OTS to be guided by the GSE charters - as well as by the other regulators - in limiting the types of credit enhancement allowed. OTS has proposed to permit mortgages backed by certain types of collateral, by letters of credit or (by implication) also by credit derivatives to qualify as "prudent" loans that will receive a 50% risk weighting. The experience of MICA members with the very substantial risks associated with high-LTV loans leads us to urge extreme caution with regard to alternative credit enhancements.

The GSEs and other bank regulators have allowed loans backed by mortgage insurance (MI) to count as prudent ones because the risks of high-LTV mortgages can be deceptive. Losses occur not only on a loan-by-loan basis, but also in portfolios that are subject to catastrophic losses. This was, for example, the case during

the mid-1980s in the Texas-South Central region and in the early 1990s in California. Throughout the 1980s, the MI industry absorbed \$5 billion in claims - largely from thrift associations and the GSEs. Had MI not been in place, the taxpayer losses associated with the S&L debacle would have been far greater.

Below, we comment on specific alternatives to MI as a permitted form of credit enhancement. We would note as a general preface to these comments that OTS has not proposed any of the protections included in the Basle risk-based capital proposal with regard to credit risk mitigation. The new Basle rules will permit capital recognition for certain types of collateral, loan insurance, guarantees or derivatives, but only under strict supervisory conditions that ensure that institutions have the necessary risk management practices in place. Further, the Basle rules alter the capital treatment by the rating of the counterparty. In contrast, OTS is proposing to allow any counterparty with any rating - or indeed even a thrift affiliate - to provide credit risk mitigation for which capital relief is provided. Allowing alternative forms of credit enhancement to provide capital relief without also imposing the strict supervisory standards in the Basle rules would set the stage for significant losses at savings associations.

#### **A. Reliance on Collateral**

MICA urges OTS to proceed with caution with regard to recognizing cash or bond collateral as an alternative to MI. While there is little credit risk associated with such instruments, there can be significant operational risk with regard to the counterparties posting such collateral. There can also be basis risk if the bond collateral does not match the mortgages. We believe that many thrift institutions and their examiners lack experience with sophisticated collateral arrangements and that these therefore should not be allowed. Certainly, they should not be allowed without imposition of the internal risk-management standards detailed in the Basle proposal.

## **B. Letters of Credit**

OTS has also proposed allowing letters of credit (L/Cs) to back high-LTV mortgages, even if the L/C is provided by an affiliate. MICA believes that such arrangements are fraught with potential conflicts of interest and should not be allowed. An affiliate providing a L/C will have a strong incentive to under-price for the risk coverage provided, in contrast to an objective third party. MICA members are regulated by the state insurance commissioners and required to hold significant amounts of capital to back the risks associated with high-LTV mortgages. In contrast, the capital rules governing L/Cs are far more lenient, reflecting the lower risks usually associated with such instruments. This regulatory construct is not appropriate to credit enhancements for high-risk mortgages, especially for inter-affiliate transactions.

We urge OTS not to allow L/Cs to back high-LTV mortgages. At the very least, however, any such arrangements should be covered by inter-affiliate transaction limits comparable to those in Sections 23A and 23B of the Federal Reserve Act to prevent self-dealing.

## **C. Credit Derivatives**

Finally, we urge OTS not to permit credit derivatives to be used as a substitute for mortgage insurance. Credit derivatives are untested, variable in structure and subject to considerable counterparty risk. Allowing lenient capital treatment for assets backed by them would create a strong incentive for savings associations to use credit derivatives in favor of tested and reliable forms of credit enhancement, significantly increasing the risk that thrifts will find themselves unhedged to credit losses during a serious downturn.

Residential mortgage credit risk derivatives remain an untested product with limited use in the financial system. We note, for example, that there is currently no generally accepted way to

mark credit derivatives to market. Further, considerable legal ambiguities surround these instruments. Estimates of \$362 billion of total credit derivatives booked in the United States is in stark contrast to the \$39 trillion (notional value) U.S. market for more established derivative products.

We suggest caution even for mortgage credit risk derivatives collateralized by cash or government securities. In January, the Basle Committee on Bank Supervision outlined the criteria by which risk mitigation devices should be evaluated for capital reduction purposes. Issues such as legal certainty and a demonstrated historical ability to absorb risk are among the factors used to compare derivatives, guarantees and insurance. The concerns expressed above for cash and bond collateral as a substitute for MI are exacerbated when the collateral is associated with complex derivative structures.

### **Conclusion**

MICA respectfully urges OTS to move with caution in adjusting the LTV for mortgages that qualify as "prudent" ones. Top-of-the-cycle analyses based on limited data sets should not guide regulatory action, which should instead err on the side of extreme caution in setting risk-based capital standards.

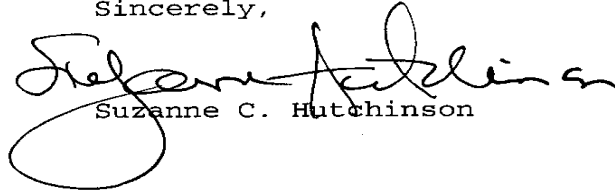
MICA also urges OTS to use an abundance of caution in determining the types of credit enhancement that qualify mortgages for favorable capital treatment. Most thrifts lack the risk management experience necessary to accept collateral in place of loan insurance. Letters of credit present the same risk management issues, but these are compounded if L/Cs from affiliates are permitted. Credit derivatives present novel risks, reflecting the fact that these instruments remain an untested way to absorb mortgage credit risk. Without strict risk management standards and limits on the types of counterparties allowed to provide mortgage credit enhancement, any liberalization of the capital rules will set the

stage for significant losses at savings associations.

We urge OTS to retain its current rules, allowing only eligible mortgage insurance to back high-LTV mortgages receiving favorable capital treatment.

We would be pleased to provide additional comments or answer any questions you may have.

Sincerely,

A handwritten signature in black ink, appearing to read "Suzanne C. Hutchinson". The signature is fluid and cursive, with a large loop at the end of the last name. It is positioned above the printed name.

Suzanne C. Hutchinson