Mortgage Insurance Companies of America

Suzanne C. Hutchinson
Executive Vice President

March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Docket Number 06-15
Via email to regs.comments@occ.treas.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1238
Via email to regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AC96
Via email to Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2006-49
Via email to regs.comments@ots.treas.gov

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

Ladies and Gentlemen:

The Mortgage Insurance Companies of America (MICA) are pleased hereby to comment on the agencies' notice of proposed rulemaking (NPR) on the revisions to risk-based capital generally known as Basel IA. Aspects of this comment parallel views we provided on the accompanying Basel II NPR, with some comments and data duplicated here because of their relevance also to this proposal. We have gone into considerable depth on several of the questions asked about the proper risk-based capital (RBC) for

1425 K Street, NW
Suite 210
Washington, DC 20005
(202) 682-2683
Fax (202) 842-9252

mortgages based on our view that it is critically important for this aspect of the rules to align regulatory with economic capital to the greatest degree possible. We understand concerns in the Basel IA context that this be done with the greatest possible simplicity, but we urge the agencies carefully to balance their desire for the lowest possible regulatory burden with the need for the best possible RBC regime.

Simplifying assumptions may be appropriate for exposures that are not significant for individual institutions or the industry, but not for exposures which – like mortgages – are major sources of credit risk. The most current FDIC data show residential mortgage exposures as 18.3% of assets at insured depositories,[1] but many banks and most savings associations have far higher concentration in this area. It is thus necessary and appropriate to develop a Basel IA methodology that captures real risk, including that involved in the increasing array of complex, non-traditional mortgage products with significantly heightened risk profiles.

Indeed, it may be appropriate for the agencies to consider improved RBC requirements for non-traditional mortgages on a stand-alone basis if the Basel process is not quickly concluded. It is unclear at this point how long it will take for the proposed regulations to take force. The longer the delay, the greater the incentives for regulatory-capital arbitrage in stressed conditions such as those now evident in the U.S. mortgage market.

Below, please find MICA comments on relevant questions in the mortgage sector in the order presented in the NPR. Key points include:

- MICA urges the agencies to set mortgage RBC based on loan-to-value (LTV) ratios, as proposed, and not to adopt the alternative which would add a "credit worthiness" factor. Below, we provide new data demonstrating that credit scores lose much of their ability to predict foreclosure likelihood under stressed conditions such as those now evident in the mortgage market. (See section III (B) below in response to questions 6, 8, and 9).

- We concur with the proposed focus on combined LTV when evaluating mortgage exposures. MICA has provided data in prior comments noting the high risk of simultaneous second liens in so-called "piggyback" mortgages. Market conditions are now demonstrating the validity of this data and, thus, the risk associated with these structures. We remain concerned that the proposed risk weightings for high-LTV second liens do not reflect the full risk of such loans. (See section V below in response to questions 12 and 13).

- We strongly support the proposed recognition of mortgage insurance. As noted below, this reflects MI's proven role as a regulated, reliable form of credit risk mitigation (CRM). We recommend that the Basel IA treatment of MI firms track that of the Basel II NPR and the international Accord, basing

[1] *FDIC Quarterly Banking Profile*, Fourth Quarter 2006.

RBC on a mortgage insurer's claims-paying rating. The claims-paying rating is directly applicable to the guarantees provided by private MI and, thus, the best determinant of CRM value. We recommend that a guiding principal for the banking agencies should be that they provide capital relief on insured high LTV loans that corresponds to the depth of coverage obtained by the bank on these loans. Thus, as the depth of coverage increases and effectively lowers the risk inherent in the initial LTV of the loan, the capital relief obtained for this coverage should correspondingly increase. (See section IV below in response to question 10)

- We believe it is critical for the agencies to review the RBC option selected by an institution if the agencies permit companies to choose between Basel I, IA, and II, with these choices compounded if a standardized option (see below) is added to the mix. Some institutions will survey these options and choose the one that results in the lowest regulatory-capital requirement, instead of picking one that best calibrates capital to risk. Although the leverage requirement, if retained, puts a floor on the degree to which capital could drop, it is far less than required for high-risk positions, such as certain subprime mortgage positions. Institutions with big books of such loans could thus elect to remain under Basel I, undermining the goals of the current rulemaking process and putting at risk such institutions and the banking system more generally. (See section I below in response to question 2)

- If the standardized option is provided, then the version included in the international Accord should be significantly revised to reflect U.S. mortgage market factors, such as the prevalence of risky non-traditional mortgage structures. (See section VII below in response to question 18)

I. Choice of Capital Rule (Question 2)

MICA understands and respects the concerns of those in the industry who have urged regulators to permit institutions to pick the RBC regime that is right for them, instead of having regulators dictate which rules must be applied. This would, for example, permit banks with very low-risk exposures (e.g., specialized banks) to select an RBC approach that, even though weightings may be higher than necessary, does not dictate extensive implementation costs not warranted by the bank's complexity or risk profile.

However, free choice could also permit high-risk institutions to arbitrage their regulatory options to pick one that does not capture their actual credit-risk exposure, even if the leverage requirement remains in effect. For example, institutions with significant concentrations in certain assets like mortgages could select Basel I or IA not only because these rules do not fully capture high-risk exposures, but also because the absence of a Pillar 2 component that captures concentration, stress testing and similar important factors would permit a more significant reduction in RBC than appropriate in light of actual risk.

MICA thus supports the NPR's suggestion that regulators will determine which RBC rule is appropriate for institutions under certain circumstances. However, given the burden on examiners at the start of the new Basel IA and Basel II rules, it may be difficult for examiners at the outset to identify situations in which rule-choice is based on inappropriate arbitrage considerations. We thus suggest that the final rule either dictate on its own or be accompanied by supervisory guidance detailing when the agencies will intervene to dictate the applicable RBC requirement.

Such standards could, for example, specify that institutions would need affirmatively to submit their regulatory-capital rule choice in advance to their primary supervisor, providing a detailed analysis of why the selection reflects the institutions' risk profile. This would put the onus on institutions to consider RBC not only on which rule gives them the best answer, but also on which in fact can be shown to reflect real risk exposures. Advance scrutiny would ensure that supervisors are not caught by surprise when subsequent market developments demonstrate that an institution's choice was, in fact, a wrong one based on overly-optimistic or even arbitrage-related considerations. These standards could also, as suggested in the NPR, define which capital rule should apply based on asset size, complexity and a bank's scope of operations, perhaps permitting institutions to appeal this selection if desired. We also concur with the NPR's suggestion that banks be allowed only to opt out of one RBC rule into another following advance notice to and approval by a primary supervisor.

II. Risk Weightings (Question 3)

MICA recognizes the need for simplified assumptions and a limited number of risk weightings in the Basel IA rule. However, we concur with the agencies' initial decision not to permit a 10% weighting for certain mortgages, as recommended by some lenders, and we urge the regulators to continue to make 20% the lowest possible risk weighting for prudential mortgages, as proposed.

The Basel IA approach does not include many of the safeguards included in Basel II. Although the leverage ratio would still apply, the IA rule would not, for example, require banks to stress-test their RBC assumptions or adjust them to reflect concentration risk. The degree to which high-risk product features (e.g., negative-amortization) are to be captured under Basel IA also remains unclear (see below). Without adding numerous conditions and qualifications to a 10% weighting for "low-risk" mortgages, this very favorable treatment could create an incentive for banks to structure mortgages to take advantage of regulatory-capital arbitrage opportunities.

As a result, it is vital that the risk weightings in all cases under Basel IA be set in a conservative fashion that appropriately balances the simplicity of the IA rules with prudential weightings. To the degree any such weightings are higher than appropriate economic capital allocation would suggest for truly low-risk loans, then this capital disparity will create the incentive regulators desire to encourage banks to migrate to the more advanced Basel II approach.

III. Mortgage Risk Weightings (Questions 6,8 and 9)

MICA strongly endorses the focus on LTV in the Basel IA NPR. We concur that LTV should always be known to a lender, thus making it a useful risk predictor that does not impose additional burden. We also agree that an alternative approach, which would combine LTV with "credit worthiness" based largely on credit score, is both over-complex and unreliable. Below, we present new data on credit-score performance under stress which, we believe, amply demonstrates that credit scores should not be used to set RBC. We also address how non-traditional mortgages should be treated, building on the proposal that the agencies retain their right to require additional capital when the IA risk weightings do not effectively capture mortgage-related risk.

A. Use of Credit Scores

As in our Basel II comment letter, we believe that credit scores are useful in modeling expected losses and for risk-based pricing under normal economic circumstances. However, historical experience and current experience in the subprime and non-traditional mortgage arena shows clearly that credit scores are not reliable predictors of probability of default (PD), loss given default (LGD) and unexpected loss under stress conditions. Institutions that over-relied on credit scores in underwriting their recent mortgage books have experienced painful and costly surprises. "What is now clear is that FICO scores are less effective or ineffective when lenders are granting loans in an unusually low interest-rate environment," Douglas Flint, HSBC's finance director, was quoted as telling investors in December.[2]

Further, severe strains so far have occurred during periods of economic stability and only modest house-price declines (although these are, of course, beginning to worsen). When market stress occurs, even if not exacerbated by interest-rate risk, MICA data demonstrate that credit scores are highly unreliable predictors of PD, with PD actually performing in highly unexpected ways.

In addition, the NPR correctly notes numerous operational issues raised by use of credit scores. These include regional disparity, especially when borrowers are not geographically diverse; how often credit scores should be updated; and treatment of borrowers with multiple credit scores, loans with multiple borrowers with different probabilities of default, poor credit-report data, and individuals with insufficient credit history to calculate a probability of default.

The NPR specifically requests comment on the use of both LTV and credit scores in setting minimum capital requirements. There are significant differences between LTV and credit scores (or other borrower attributes). Lower LTVs, or equivalently, higher MI coverage, provide additional equity protection that warrant direct dollar-for-dollar

[2] FAULTY ASSUMPTIONS: In Home-Lending Push, Banks Misjudged Risk, Carrick Mollenkamp, *Wall Street Journal*, February 8, 2007.

reductions in risk-based capital requirements. Although higher credit scores will imply lower values of PD, they are not a direct substitute for lower LTVs or deeper MI coverage in offsetting unexpected losses (UL) and should not be treated as equivalent forms of protection.

B. Credit Scores as a Predictive Factor During a Period of Housing Market Stress

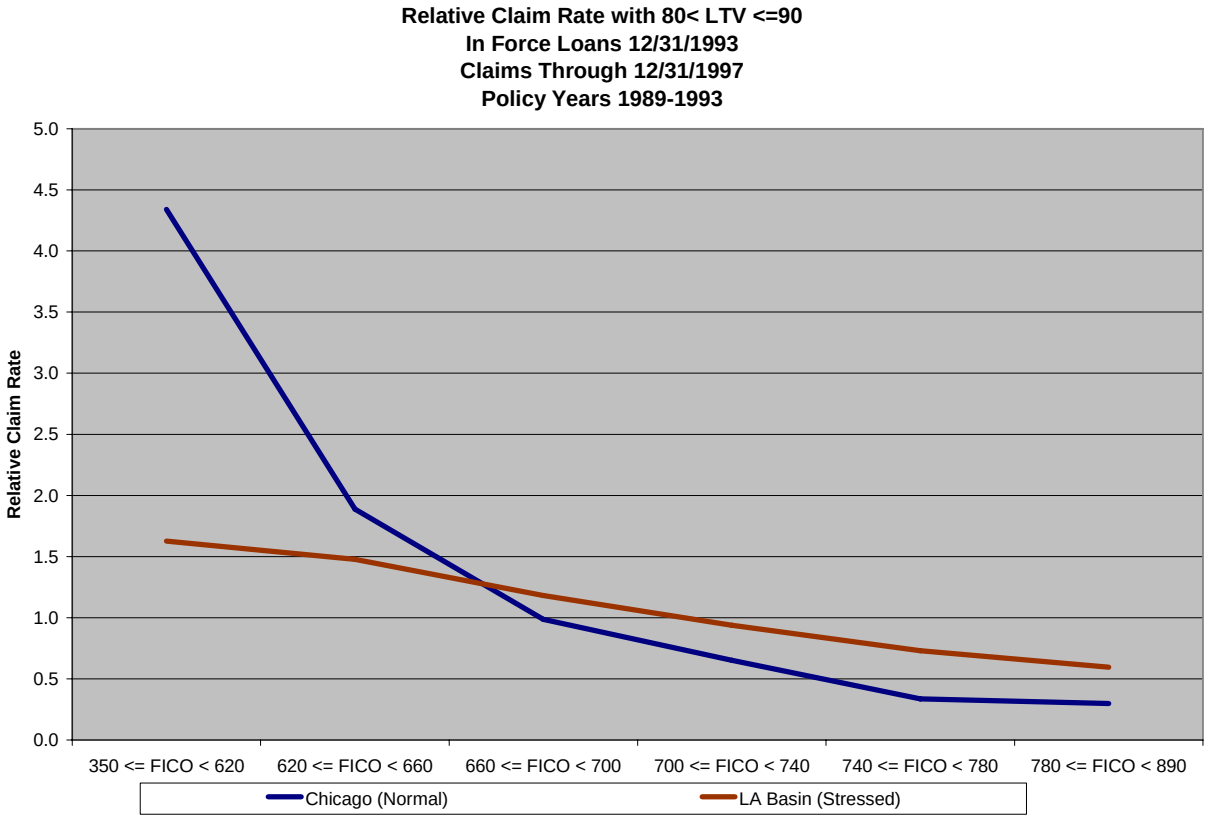
MICA members have analyzed their industry data and produced conclusive evidence that credit scores, while highly predictive of foreclosure rates under normal housing market conditions, lose much of their predictive power under stressed market conditions. Furthermore, the study shows that the impact of housing market stress overwhelms the impact of credit scores as a determinant of ultimate foreclosure rates.

The MICA study data consists of loans insured by four MICA member companies where MI coverage was in force as of December 31, 1993 in the greater Chicago and Los Angeles metropolitan areas. These two geographic markets were chosen to represent a "normal" housing market (Chicago, 3.7% average annual appreciation 1993Q4-1995Q4) and a "stress" housing market (Los Angeles, -4.0% average annual appreciation 1993Q4-1995Q4). All of the loans had original LTVs above 80% but not higher than 90%, all were underwritten to “prime” loan underwriting standards that existed at that time and all were fully documented. Importantly, at the time these loans were originated the borrower’s FICO score was not an underwriting criterion for a prime loan. However, each of the loans analyzed in this study had a known FICO credit score at or near the time of the loan’s origination. The population of these loans with known FICO scores includes origination years 1989 and later.

MICA grouped the loans according to FICO score ranges that are commonly used in the industry, measured the cumulative claim rate through the end of 1997, and compared the claim rates across FICO score ranges and the two markets to create relative claim rates. The definition of a mortgage insurance claim is sufficiently close to that of a foreclosure, that claim and foreclosure may be used interchangeably in this discussion.

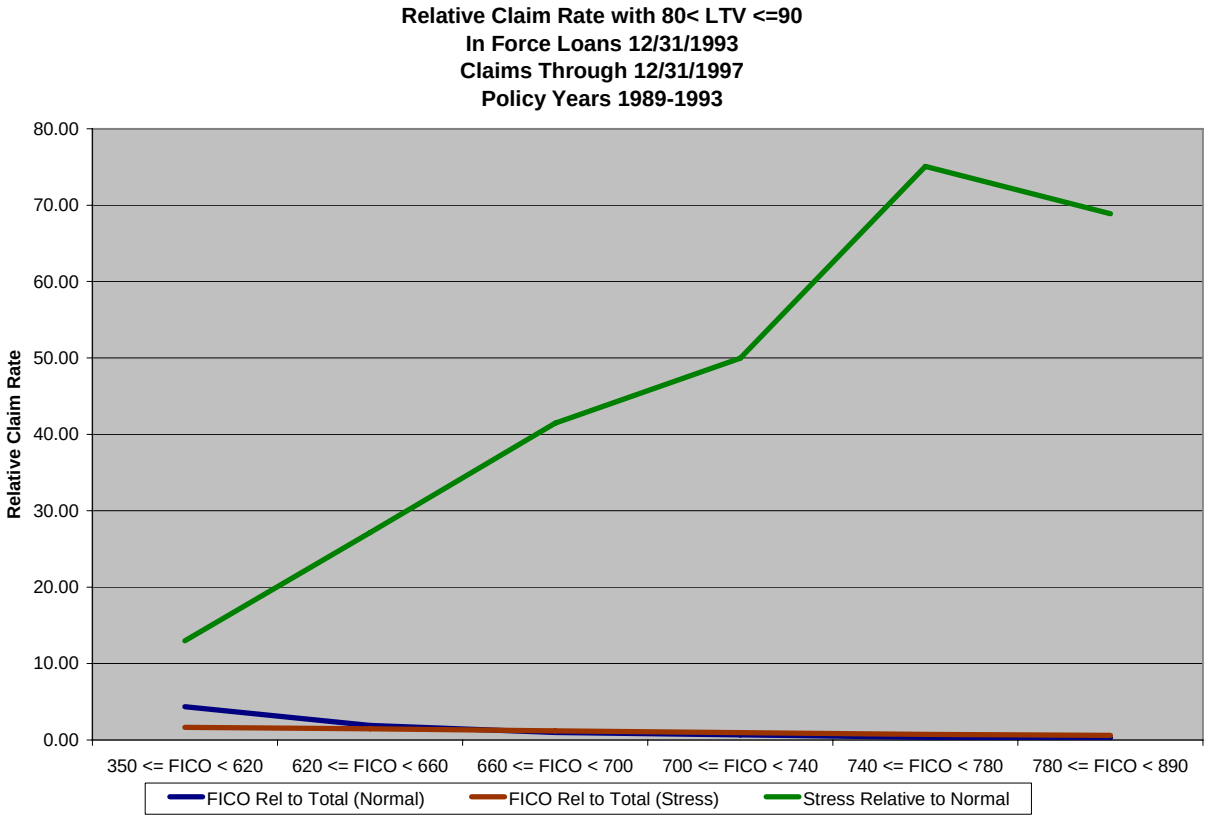
In Figure 1, we show the claim rate for each FICO range, relative to the overall claim rate for the market. In the normal market (Chicago), the lowest FICO range (<620) had a claim rate that was 4.34 times the overall claim rate for the market, while the claim rate for the highest FICO range (>=780) was 0.30 times the overall rate. This relationship corresponds well to the “expected” relationship between credit and PD. In the stressed market (Los Angeles), the relationship between FICO and claim rate is noticeably weaker. The claim rate for the lowest FICO range is only 1.63 times the overall rate, and the claim rate for the highest FICO range is 0.59 times the overall rate.

Figure 1



While Figure 1 amply demonstrates the reduced importance of credit scores in determining claim rates in a stressed housing environment, Figure 2 illuminates why this is the case. In Figure 2, we add to the previous graph the claim rate for the stressed market relative to the normal market for each FICO range. The claim rate in Los Angeles for loans with FICO scores less than 620 was 12.97 times the claim rate in Chicago for the same period. As FICO scores increase, the impact of stressed housing markets increases substantially. In the highest FICO range, where scores are 780 or greater, the claim rate in Los Angeles was 68.87 times the claim rate in Chicago. Clearly the impact of the stressed housing market makes the FICO impact all but vanish.

Figure 2



This last point cannot be overemphasized. Risk based capital is what lenders must hold to protect against unexpected risk. The data presented here starkly illustrates the conclusion that, while credit scores are highly correlated with expected risk, they have very little correlation with unexpected risk. Unexpected losses in mortgage lending are driven, more than anything else, by declines in home prices. Declining home values are a great equalizer in a mortgage portfolio, affecting all borrowers regardless of their prior credit history. Consequently, the gap between expected and unexpected foreclosure rates is actually significantly higher for borrowers with high credit scores. MICA concludes from this evidence that, while credit scoring is useful for pricing and reserving applications, it is not useful for setting capital requirements. As a result, we recommend that the regulators not include borrower credit scores in determining risk weights for mortgages.

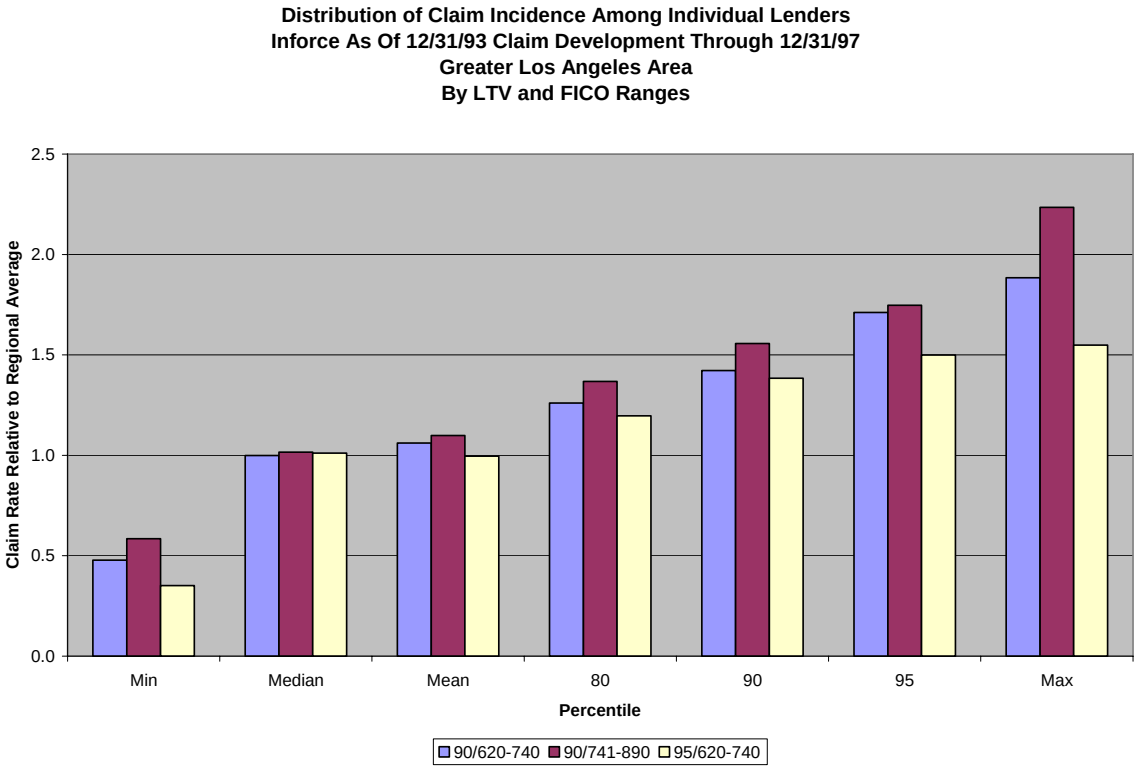
C. Setting Capital Rates That Are Sufficient For Most Banks

MICA recommends that the Regulators consider the impact of setting capital levels based on aggregate industry stress loss levels. The loss experience for individual banks can be expected to vary from the aggregate industry results. To the extent that distribution is close to normal, that is, the median loss experience for individual banks is close to the overall average, setting capital levels to the average experience means that

only 50% of the banks will actually have sufficient capital. In order to ensure sufficient capital at the great majority of banks, the loss experience used to determine the proper amount of capital must be somewhat higher than the average.

MICA member companies, using the same data from their study of FICO scores in a stressed market, measured the empirical distribution of claim incidence among individual lenders in Los Angeles between 1993 and 1997. The population studied was limited to lenders with at least 100 loans in each of three combinations of original LTV and FICO score range. The three ranges were chosen because they include a sufficient number of lenders on which to draw conclusions regarding the distribution of claim rates. In Figure 3 we present some results from that study. The figure shows claim rates in LA, relative to the overall average claim rate for each of the three LTV/FICO groupings. In each of the three groups, the median lender experience is very close to 1.0 times the overall average. In order to generate sufficient capital for 80% of the banks, a foreclosure rate of 1.2 to 1.4 times the average stress rate would need to be used. Sufficient capital for 95% of the banks would be produced using foreclosure rates 1.5 to 1.7 times the average stress rate. In order to guaranty sufficient capital at every lender, foreclosure rates 1.5 to 2.2 times the average stress rate would have to be used.

Figure 3



D. Current Versus Original Credit Score

All of the previous performance analysis was put together using credit score and LTV at origination. MICA understands that some lenders have proposed that all credit scores be updated on a regular basis so that capital might be maintained on a current risk to capital basis. MICA strongly believes that the use of "current credit scores" would result in a decidedly pro-cyclical mortgage capital regime with many additional regulatory and operational problems.

First, as we note throughout these comments, credit scores are effective predictors for expected loss only – not unexpected losses. Consequently, updating credit scores will do nothing to assess the risk associated with unexpected losses experienced under stress – something the Basel process is meant to address. Updated credit scores might help a company reserve for expected losses – but will do nothing for unexpected losses and certainly should not be used to change the capital allocation for the subject loans.

MICA believes that the use of updated or "current" credit scores would not solve the volatility of "original score-based loan performance", but rather, would exacerbate the problem of pro-cyclicality in the Basel IA approach – a problem that is already present in the A-IRB approach under Basel II which will rely on benign scenario market performance as the basis for its capital estimates.

E. Negatively Amortizing and Other Non-traditional Mortgages

As noted, MICA has considerable concern that current RBC standards and even the leverage requirement do not adequately capture the economic risk of certain non-traditional mortgage (NTM) structures. It is for this reason that we urge the regulators to move separately on express NTM capital standards, especially given the potential for delays in the Basel IA and Basel II rulemaking processes. In the Basel IA NPR, you note that, in addition to the proposed new LTV-based risk weights, the agencies will reserve their right to require additional capital for higher-risk mortgages. MICA supports this but recommends that the regulators detail more clearly when additional capital will be imposed. Reflecting the need for simplicity in the IA regime, the agencies need not necessarily detail how much RBC would be required, but clarity on when it should be held would ensure unanimity on this critical point among the agencies, guide institutions and examiners and promote the housing-market and consumer-protection concerns expressed in the agencies' recent guidance on NTMs and the proposed standards for subprime mortgages

MICA believes the NPR correctly specifies the treatment of loans with funded and unfunded components when calculating the risk weight on a junior lien with a senior negatively amortizing first. The NPR states that the first lien should be considered at the maximum contractual loan amount when calculating the combined LTV for the junior lien. This language correctly recognizes the contributory risk of the negatively amortizing first lien in the structure. In contrast, when determining the risk weight for a stand alone first lien, the NPR separates the funded and unfunded portion of the product,

categorizing the product as a lower risk based upon its initial funding, and differentially weights the two components.

Negatively amortizing products have been untested in stress markets. A study by Fannie Mae showed that even in the supportive economic environment of the past few years, roughly 75 percent of borrowers chose to allow their balances to grow.[3] The trend in the percentage of borrowers selecting that option also increased from 2004 to 2006. At the point which these products reach reset and enter their peak loss period, the LTV based upon maximum contractual loan amount is more representative of the driver of loan behavior and value at risk. The trend in borrower selection of the negatively amortizing option supports MICA's view that the maximum contractual loan amount should be the sole determinant of risk weight.

For consistency and simplicity, it is recommended that risk weights not be segmented for a loan's funded and unfunded components. Thus, in the example provided in Table 4 (p77458), the indicated risk weights for both components should be 75%. This would be consistent with the approach taken on page 44759 of the NPR from the paragraph immediately following Table 5. For consistency across all products with funded and unfunded components, such as HELOCs, this same approach to using the LTV (or combined LTV for junior liens) based upon the maximum contractual loan amount to determine risk weight should be applied.

IV. Treatment of Mortgage Insurance (Question 10)

MICA supports the recognition of private loan-level mortgage insurance in the Basel IA NPR, which we believe creates an appropriate incentive for use of proven credit risk mitigation that meets the regulators' goal of aligning regulatory with economic capital. As detailed in our prior comments to the regulators and in our Basel II comment, MI is markedly different from many other types of CRM. It is, for example, regulated and capitalized to absorb mortgage risk, in sharp contrast to credit-derivative structures yet to prove their ability to absorb default-risk under stress scenarios. In a recent speech, the current president of the Basel Committee, Dr. Nout Wellink, rightly makes CRM quality a top supervisory priority, calling for careful attention to the ability of credit-risk-transfer parties in fact to honor the commitment they make.[4] By limiting favorable LTV treatment to loans backed by MI, the Basel IA NPR meets this important goal.

Following are specific comments on MI-related issues in the NPR:

---

[3] Economic Commentary, February 20, 2007, "Delinquencies on NegAm ARMs Remain Low, Even as Balances Increase", Anton Haidorfer, Fannie Mae Economics and Mortgage Market Analysis

[4] Remarks by Dr. Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the GARP 2007 8th Annual Risk Management Convention & Exhibition, New York, 27 February 2007. Available at http://www.bis.org/review/r070228a.pdf

A. Eligible mortgage Insurance Providers

The Basel IA NPR is at variance with the international Accord and the Basel II NPR in one respect, which may well be a technical error not consistent with the agencies' intent. Specifically, the Basel IA NPR defines eligible MI coverage as that provided by an insurer with senior long term debt rated at least third-highest investment grade (without credit enhancements) by a NRSRO. In contrast, the Basel II NPR links eligibility to a senior debt rating in one of the two highest investment grade ratings or, more importantly, to "claims payment ability that is rated in one of the two highest categories by an NRSO." Claims payment ability, not debt, ratings are the appropriate criterion under Basel IA

All mortgage insurance companies are AA-rated or better as claims-paying entities. Even though an MI company with a AA claims-paying rating may have the same senior long-term debt rating as a non-insurance A-rated company, its claims-paying ability is higher. This is because any guarantee offered by the non-insurance A-rated company will be treated the same with all other creditors in the event of a default. However, for an MI company, all debt, including senior long-term debt, is subordinated to the interests of the policyholders. Consequently, there is less risk that MI policyholders will not be paid as compared to the risk associated with a normal corporate guarantee.

B. Affiliated Entities

The NPR seeks comment on whether LTVs should be adjusted to reflect MI provided by mortgage insurer that is "affiliated" with the bank, also requesting comment on the treatment of MI where mortgage reinsurance is provided by a captive owned by the lender. We here provide MICA views on both of these important questions.

First, MICA believes that MI provided by an affiliate of a bank should not count towards the LTV on which the risk weight is based. This would, we think, be akin to permitting a bank to "guarantee" a corporate loan and thus have the risk tied to the bank's debt rating, not the risk of the obligation itself. Such self-insurance is of course dangerous and in sharp contradiction to the risk-management incentives of the Basel Accord. For purposes of determining when a mortgage insurer is an "affiliate," and thus when coverage does not count for RBC purposes, the regulators should ensure that indirect and direct affiliates are covered.

However, we do not recommend an express ban on MI when there is a captive mortgage reinsurer affiliated with the bank. In these arrangements, an originator establishes a captive reinsurer that takes a portion of the risk associated with its book of business. First and foremost the point should be recognized that the obligation for payment of claims to policyholders remains with the private mortgage insurer, irrespective of whatever reinsurance arrangements exist or whether the reinsurer performs. Additionally, these arrangements are robust ones in which the MI, not the

captive reinsurer, determines the mortgage-insurance underwriting criteria, sets the cost of coverage, and absorbs the bulk of the risk. Nothing in these arrangements thus undermines the value MI provides as a proven form of credit-risk mitigation that should be fully reflected under Basel IA.

C. Depth of MI Coverage Should be Reflected in RW Reduction

We recommend that a guiding principal for the banking agencies should be that they provide capital relief on insured high LTV loans that corresponds to the depth of CRM coverage obtained by the bank on these loans. In order to provide adequate benefit to reduce credit loss severity for unexpected losses, the banking agencies should assure that RW reduction would offset the intrinsically higher default frequency that the higher LTV loans experience. Thus, as the depth of insurance coverage increases and effectively lowers the risk inherent in the initial LTV of the loan, the capital relief obtained for this coverage should correspondingly increase. The standard coverage requirements specified by the housing government sponsored enterprises for sellers of high LTV loans include provision for mitigating costs of holding and disposing of mortgaged collateral recovered because of default and these factors should be included in the calculation employed by the banking agencies to assess the capital relief obtained by MI coverage.

V. Second Liens (Questions 12 and 13)

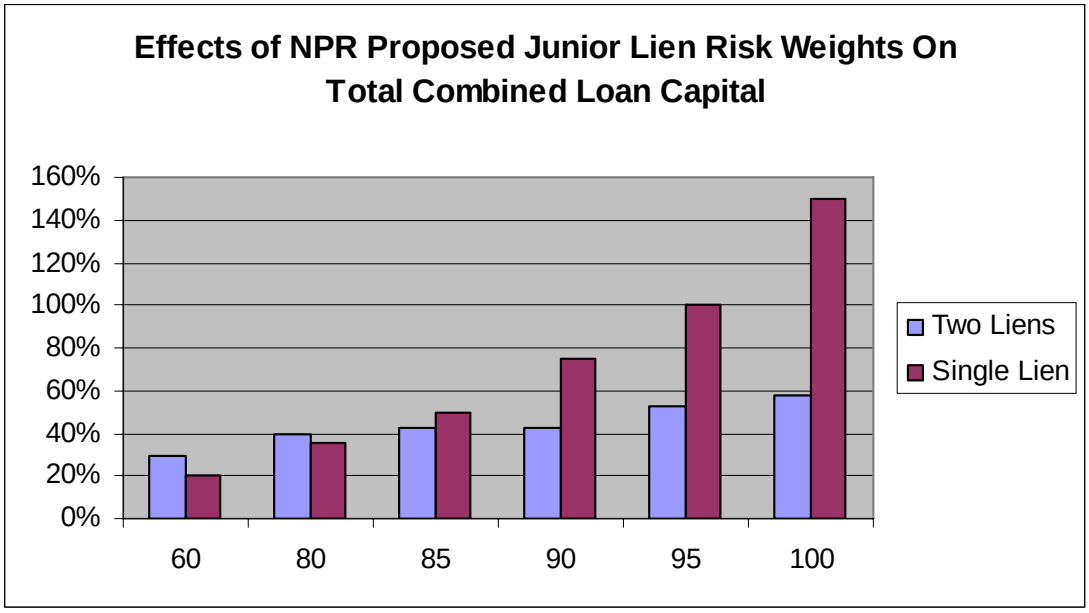
MICA supports the proposal to combine any stand-alone second liens with all more senior ones (regardless of who holds them) to determine LTV for purposes of assigning a risk weight. We believe that mortgage risk is determined primarily by the borrower's equity, not the loan structure and who holds portions of it. As a result, the treatment of second liens should be consistent in Basel IA, regardless of the holder of any first lien related to the second one. This is important not only for the principle outlined above, but also because mortgages are often structured into first and second liens, with the first lien sold to a GSE or investor. Failure to ensure that second liens in this common product (often called a piggyback" mortgage or, as in the NTM guidance a mortgage with a "simultaneous second lien") are appropriately captured under Basel IA would contribute to product structuring and, thus worsen regulatory-capital arbitrage.

MICA also remains concerned that the proposed risk weightings for high-CLTV second liens do not reflect the full risk of such loans. In MICA's previous comments[5] we suggested that the RBC on the combined senior and junior positions should at least equal that of a single first lien with the same LTV as the combined loans. We reiterate this position as a statement of principle that should guide regulation. Unfortunately, the risk weights proposed in the NPR do not adequately serve that principle. The table below compares the risk weights of various single loans to alternative structured loans, as proposed in the NPR. For the structured alternatives, the computed risk weight is the average of the first and second lien risk weights, weighted by the proportions of each in the combined loan amount. There is a clear incentive for lenders to split their high LTV

[5] See MICA comment letter Docket No. 05-16 January 18, 2006.

loans into two pieces and move one of them out of their portfolio, reducing RBC by as much as 61%.

Most Common 2 Loan Combos	2 Loan Splits First	2cnd	NPR Proposal RWs First	2cnd	Two Liens	RW Single Lien	Required 2cnd RW
60	50	10	20.0%	75.0%	29.2%	20.0%	20.0%
80	60	20	20.0%	100.0%	40.0%	35.0%	75.0%
85	75	10	35.0%	100.0%	42.6%	50.0%	200%
90	80	10	35.0%	100.0%	42.2%	75.0%	400%
95	80	15	35.0%	150.0%	53.2%	100.0%	400%
100	80	20	35.0%	150.0%	58.0%	150.0%	600%



The implied risk weights necessary for junior liens, to make the total RBC held against the pieces of a structured loan equal to the RBC held against an equal single lien loan, are very large. For example, in the last row of the table, a risk weight of 610% would be needed on the 20% junior lien to bring total RBC to a 150% risk weight. This difficulty in assigning risk weights to the pieces of debt secured by a particular home, that the "risk" is harder to assign to the individual pieces, results from the risk being spread unevenly over the pieces. The risk (PD) on the first lien is amplified by reducing or extinguishing the borrower's equity through adding subordinate lien debt. If that additional risk is not reflected by an appropriate increase in RBC on the first lien, the entire amount of additional risk must be supported by RBC against the junior lien. Requiring the second lien to carry additional RBC for an exposure four times larger inevitably leads to what appear to be extreme risk weights.

The extreme risk weights, however, may well be justified. When a lender originates simultaneous liens, clearly the lender know about both pieces and can be required to hold sufficient, proportionate capital against each piece. Even if the lender subsequently moves one of the liens off their balance sheet, they could still be required to treat the remaining exposure on the basis of the combined LTV. The NPR as written provides considerable incentive for lenders to avoid learning of junior liens (don't ask, don't tell), and in many instances the holder of a first lien can honestly report no knowledge of junior liens. The capital rules must be designed to account for all of these scenarios. Punitive risk weights on junior liens accomplish two valid regulatory goals: they ensure sufficient capital in the banking system to cover the risk the junior liens create both for themselves and the senior liens; and they serve as a strong disincentive to hide risk through structured transactions. To the objection that the total capital will not be held in the correct components of the system, the appropriate response would be that the product developers who inject large amounts of additional "invisible" risk into the financial system should either hold the extra capital needed to cover that risk, or make the risk visible to the holders of the assets affected by that risk, who could then be required to hold the needed capital.

Finally, consistent with the credit-score data presented above with regard to first liens, MICA opposes use of "credit worthiness" as a criterion by which RBC is set for second liens. We believe our data fully demonstrate how unreliable traditional credit scores have proven under stress scenarios. Second liens are, of course, the highest-risk piece of a mortgage and thus it is even more important to ensure a conservative, proven approach to setting RBC for second liens.

VI. Transition Rule for Mortgages

MICA does not believe it appropriate to provide the proposed "transition rule" for mortgages, under which institutions could keep all current mortgage exposures under Basel I as new ones are covered under Basel IA. We believe the regulators have proposed an RBC regime that is simple enough to be applied retroactively, as well as prospectively.

There is a ready, efficient secondary market for a wide range of mortgage products. Thus, institutions not wishing to hold higher RBC for higher-risk mortgages could easily sell them into the secondary market when Basel IA is in place. Institutions that elect the transition rule and, thus, keep Basel I in place, may do so to avoid the recognition of impaired value that would result if mortgages were sold into the secondary market. This could create large asset classes that are significantly under-capitalized, undermining the goal of Basel IA.

VII. Standardized Option (Question 18)

As noted in our comments on Basel II, MICA recognizes that a number of interested participants in discussions on the topics treated in the NPR have recently argued that the U.S. should adopt the standardized option included in the international Basel II Accord. Proponents of this approach believe that it would ensure competitive parity between large U.S. banks and foreign firms, as well as ease the "home/host" issues raised by disparities between the U.S. Basel II A-IRB and that approved elsewhere. If the regulators decide to permit a standardized option, this should be significantly revised from the version finalized in the international Accord. That option provides clear RBC treatment only for traditional mortgage structures and is, as Chairman Bernanke has noted[6], unsuitable for use in the U.S. Based on the need for such revisions and the importance of this capital requirement, MICA concurs that another round of public comment, hopefully on an accelerated schedule, is appropriate if the agencies propose the standardized option.

MICA does not oppose a regulatory-capital option simpler than the A-IRB for large banks. This position is based in part on our view that, the longer Basel I remains in place, the greater the prospects for regulatory-capital arbitrage with complex products unanticipated in the 1988 rules. While complex standards that closely align regulatory with economic capital are the best option, regulatory standards that at least bring capital closer to economic capital would be far better than the prevailing capital standards and, thus, promote improved safety and soundness. Moreover, simpler options would have less implementation cost than the more complex ones, easing the transition to full Basel II implementation and, perhaps, eliminating the need for unnecessary modeling and related costs at banks with simple, high-quality credit-risk positions.

However, we urge considerable care in structuring any alternatives to the A-IRB and another round of full public comment should the agencies be inclined to authorize any such option. Unless carefully structured, a standardized option could exacerbate the prospects for regulatory-capital arbitrage, especially for banks with high-risk positions. Such banks may elect the standardized option not because it is appropriate for them, but rather because the simpler assumptions in it permit lower risk weightings than the A-IRB. Parallel runs between the standardized and advanced options -- which would protect the agencies from such arbitrage -- are not feasible because of the cost of the advanced runs, which would negate much of the desired benefit for the standardized option. Thus, the regulators will need to develop tough screens and robust risk weightings for high-risk positions before any standardized alternative to the A-IRB is permitted.

Further, MICA urges the agencies not to adopt the international standardized option with regard to mortgages. As you know, the standardized option provides for a 35% for prudential mortgages and unspecified higher rates for all others. The definition of prudential mortgages eligible for the favorable risk weighting is rightly based on LTV, but this may mask numerous other factors that can exacerbate credit risk. For example, the U.S. has an array of mortgage structures – hybrid adjustable-rate mortgages and no-documentation ones – that may pose significant risk despite the nominal LTV. Further, the international standardized option does not make clear that LTV must be assessed on a

[6] "Bernanke in Letter, Defends 'Advanced' Basel II Approach," *Dow Jones Newswires*, September 5, 2006.

combined basis with any second liens issued simultaneously with the first lien – again, a widespread U.S. practice generally not found abroad.

The risks of the weightings in the standardized option are still more acute for the higher-risk mortgages that come under the higher weightings. Here, LTVs on the first lien could be 100% or even higher and other facets of the mortgage structure – e.g., interest-only, negative-amortization, no documentation, etc. – may exist.

If the regulators decide on a standardized option, then we urge consideration of the clearly differentiated risk weightings proposed under Basel IA rather than the discretionary, unspecified imposition of higher risk weightings for higher risk mortgages. Without a clear standard set by rule, significant differences between agencies could occur with undesirable competitiveness implications. MICA believes the proposed risk weightings under Basel IA provide a clear framework for the standardized option that should be adopted if the standardized option is made available.

Conclusion

Again, we thank you for your consideration of our views and stand ready to provide whatever additional information is of use.

Sincerely,

Suzanne C. Hutchinson