MICA

Mortgage Insurance Companies of America

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To Whom It May Concern:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the bank and thrift regulatory agencies' proposal to create a separate (i.e., bifurcated) capital system for small banks and small thrifts. MICA is the trade association of the nation's primary mortgage insurance industry. As such, we have a keen interest in any proposal that affects the safety and soundness of the banking system. The ability of insured depositories to provide an ample supply of prudent mortgage credit is of major importance to mortgage insurers, and we thus carefully follow rules which, like this one, might adversely affect the nation's housing finance system.

MICA believes that it is essential that appropriate amounts of leverage and risk-based capital (RBC) back the risk taken at all insured depositories, regardless of their size. The nation and its taxpayers have had sorry experiences with the cost of the failures at small banks and thrifts, many of which would be exempted under the proposed bifurcated capital structure.

From 1980 to 1994, 2605 insured depositories with $500 million or less in assets failed.[1] As the agencies know, banks and thrifts are also disproportionately costly to the FDIC when they fail because many of their assets are not liquid. When the relatively small Keystone National Bank failed in 1999, its cost to the FDIC represented seventy to eighty percent of its assets – a high

[1] We have derived this figure based on FDIC historical data.

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ratio, but certainly not unprecedented in the annals of small bank and thrift resolutions. Using a more conservative resolution cost estimate of 40% of bank assets and an assumption that the average size of the institutions that failed from 1980 to 1994 was $200 million, the cost of these failures would have been $208.4 billion.

MICA is particularly concerned with the proposed adoption of a leverage ratio as the sole capital requirement for smaller institutions. Regardless of whether a leverage ratio is imposed on all assets or only, as is now the case, on on-balance sheet ones, it is a crude capital measure that creates perverse incentives for undue risk-taking. If, as suggested in the advance notice of proposed rulemaking (ANPR), the current leverage ratios are increased in an attempt to compensate for the elimination of RBC, then this problem is exacerbated. If small banks have to meet higher leverage ratios, they will surely take greater risks to maintain or improve their returns, arbitraging the failure of the capital scheme to capture and capitalize such risks.

Specifically, MICA urges the regulators:

- to act with considerable caution in crafting a separate capital structure for small institutions. While we recognize that the new Basle rules will be quite complex, an over-simple alternative could threaten the solvency of the deposit insurance funds and create serious market distortions. We propose another approach below;
- to avoid reliance on leverage ratios alone; and
- to ensure that the final capital rules for all banks and thrifts provide adequate credit for bona fide credit risk mitigation measures.

1. Risks of a Bifurcated Capital Scheme

As noted, MICA recognizes that the new Basle RBC proposal is very complex. However, this results from the regulators' correct desire to capture in risk-based capital the complex risks large institutions now run. The agencies have rightly noted the skill with which banks now arbitrage the current RBC rules, and we concur with the Basle goal of structuring new rules that address this growing practice.

However, we would note that the small "traditional" banks the agencies propose to exempt from the RBC rules do not have the types of complex on- and off-balance sheet assets at which the new rules are aimed. As a result, much of the complexity in the new rules will not affect them. Those small banks with complex portfolios should in fact be covered by the new rules, or they will surely game any system the agencies create to take on far more risk than is reflected in their capital positions.

In the ANPR, the agencies ask for comment on how to differentiate traditional from non-traditional small banks, as well as whether an asset cap should be used to define which institutions are allowed to use a simpler capital standard. MICA urges the agencies not to set any arbitrary standard for determining which institutions present non-traditional risks, and we also oppose use of a simple asset cap.

Instead, we recommend that the regulators develop a compliance guide to the new Basle rules to assist small banks with traditional, non-complex asset structures to comply with the new RBC requirements. This new compliance guide could omit some of the nuances of the Basle rules on the grounds that smaller institutions are unlikely to take on certain risks or make use of certain structures, but it would otherwise generally follow the new RBC framework. Institutions would, in essence, self-select to use the compliance guide to the degree that their portfolios permitted them to do so. Small banks with large volumes of non-conforming assets could not use the regulatory workbook, ensuring that they met the more complex rules appropriate to their risk profiles.

Reliance on a regulatory workbook instead of asset caps would also permit some banks and thrifts above $500 million to make use of the simpler capital rules. Some quite large institutions still choose to have relatively simple balance sheets. Those that do would benefit from the easier compliance methodology, limiting the regulatory burden of the new Basle rules to those institutions for which it is necessary and appropriate.

Specifically, MICA envisions a handbook set out by the regulators that walks banks and thrifts with traditional asset structures through the new capital rules. If they have assets that meet the definitions in the guide, then institutions need only find the appropriate risk weighting and adjust their capital positions accordingly. Only very large and complex banks would then need to understand and adopt the full scope of the new Basle rules.

The approach we recommend as an alternative to the bifurcated capital scheme has the following advantages:

- it does not involve arbitrary definitions of which institutions are simple enough or small enough to qualify for a separate capital scheme, thus eliminating the possibility of regulatory arbitrage;
- it ensures that the capital rules do not create incentives for undue risk-taking; and
- it provides a less burdensome approach to capital compliance for small institutions than the current system.

2. Risks of a Leverage Requirement

MICA urges the agencies to avoid sole reliance on leverage capital standards under any and all circumstances. We note that the RBC standards were created in the 1980s because of the widely recognized failure of the leverage rules, and we urge the agencies not to repeat the sorry experience of that decade of massive bank failures and deposit insurance losses. The problem with the leverage rules of the 1980s was not only that they failed to capture off-balance sheet assets, which the proposed extension of a small-bank leverage rule to off-balance sheet assets might address. The problem was more fundamental. Whether a leverage standard captures on- or off-balance sheet assets or both, it still acts as a capital incentive for excessive risk-taking.

Any capital system that assesses a flat percentage of capital against the nominal amount of an asset without regard for the riskiness of that asset creates an incentive for capital arbitrage. Because investors measure performance in terms of return on equity – and bank managers are often compensated accordingly – banks and thrifts (even very small ones) strive for the highest ROEs they can reach. The more capital a bank must hold, the lower its ROE unless it is able to make its equity support higher-yielding assets. Since this is possible in efficient markets only through taking on more risk, the higher the leverage capital standard, the more risky banks will become.

The current and proposed Basle rules correct this flaw by recognizing the benefits of risk mitigation through reduced capital requirements. In the U.S., for example, all insured depositories receive a 50% risk weighting for higher-risk mortgages when these are backed by private mortgage insurance. With the presence of bona fide third-party credit enhancement, such higher-risk loans are rightly deemed "prudent" in the capital rules because another entity absorbs much of the credit risk. Of course, mortgage insurance, like all forms of credit enhancement, is not free. All things being equal, banks might not incur this cost and protect their balance sheets.

The capital rules should ensure that all things are not, in fact, equal in terms of the incentives created for risk mitigation. Capital weightings should reward banks and thrifts, regardless of size, that take prudent measures to reduce their risk profile. Failing to do so runs the risk of creating the capital incentives that were one of the predicate causes of the banking crisis of the 1980s and early 1990s, surely too high a price to pay when other, less risky ways to simplify small-bank capital rules are at hand.

MICA's concern is exacerbated if the agencies, as proposed, not only adopt a leverage standard, but also raise it from current levels. This would put banks and thrifts under even greater pressure to raise their risk profiles, compounding the hazards of a leverage-based approach to capital requirements.

3. Recognition of Credit Risk Mitigation

As noted, MICA opposes a separate capital framework for small banks, preferring that agencies develop an alternative compliance program for all banks and thrifts with non-complex balance sheets. We also oppose reliance on leverage standards, as noted. However, we recognize that the agencies are considering other options. Under any circumstance, the capital rules for banks and thrifts of every size should provide a capital benefit for credit risk mitigation. Thus, should the agencies decide to structure a separate RBC system for small banks and thrifts, they should ensure that this new approach adequately recognizes credit enhancements like mortgage insurance. We would be pleased to provide detailed comments on how this might work should the agencies decide to move forward with such an approach.

Conclusion

MICA believes that the agencies should not provide a separate capital structure for small banks and thrifts. Instead, the agencies should make it easier for institutions with noncomplex balance sheets to comply with the Basle rules. A bifurcated capital scheme for small banks and thrifts will create significant opportunities for regulatory arbitrage, especially if the agencies adopt a leverage standard as a substitute for effective risk-based capital. Because even small institutions can pose substantial risks to the deposit insurance fund and to the financial system as a whole, capital for them as well as for all insured depositories should be carefully calibrated to reflect risk.

Cordially,

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