Mortgage Insurance Companies of America

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Secretary
Securities and Exchange Commission
100 F Street, NW
Washington, DC 20549-1090

File No. S7-17-08

Dear Secretary:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the proposal by the Securities and Exchange Commission (SEC) to revise the treatment of credit-rating agency (CRA) determinations in an array of SEC rules [73 FR 40088]. MICA strongly supports the SEC's efforts to improve CRA methodology and prevent conflicts of interest, and we noted this in detail in our July 25 comment to the Commission on the SEC's prior proposal related to CRAs [73 FR 36212]. We think the additional proposal is also critical and we similarly urge quick action on a final rule. Much in the SEC's proposal strikes at the heart of failures in the "originate-to-distribute" model that has been widely cited as the cause of current market problems.[1] The proposal thus is not merely one that will improve investor and regulator practice, but also one critical to stabilizing global financial markets.

The more regulators and investors use their own judgment, instead of deferring to the CRAs, the better protected financial markets will become from models risk – an often-overlooked one that has been in some ways the most significant cause of the current credit-market collapse. In the notice of proposed rulemaking (NPR), the Commission rightly notes that its own reliance on CRA determinations has helped to create a "stamp of approval" that led to undue investor reliance on credit ratings. The sooner this "stamp" is removed by the SEC and the more quickly other regulators follow suit, the better markets will

[1] See, for example President's Working Group on Financial Markets' Policy Statement on Financial Market Developments, March 2008 and Joint Forum Credit Risk Transfer Consultative Document, April 2008.

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become now and the more firmly they will be protected from future systemic risk.

Key points in our comment include the following:

- MICA strongly supports the NPR and urges that it be quickly finalized. We note that this NPR is not subject to any questions about the SEC's statutory authority because it addresses how ratings are used, not how they are derived. Thus, in the event of any debate or litigation surrounding the earlier proposal, a rule along the lines now proposed will provide essential market protection.

- If SEC rules require investors to use their own judgment, not simple unquestioned reliance on the CRAs, no undue burden will be imposed. Instead, investors will turn to a review of the degree to which risks are mitigated. Rather than trusting to complex, black box models, they will look to straight forward risk determinants such as capital and the degree to which a guarantor can in fact honor its commitments. This will return the market to proven forms of risk mitigation in the credit- and operational-risk arenas, a major reform necessary to stabilize markets now and protect them going forward.

- MICA supports the liquidity risk requirements that the SEC proposes to add to the risk requirements for institutional investors and the eligibility criteria for net-capital rules and money market fund (MMF) investments. The failure to capture liquidity risk has been a critical investor and regulatory lapse, as was made all too clear in the failure of Bear Stearns. The SEC's proposal will supplement pending supervisory liquidity standards and, thus, reinforce ongoing efforts to stabilize financial markets.

- Finally, MICA urges the SEC to work with other regulators, most notably the federal bank regulators and the Federal Housing Finance Agency (FHFA), to share the research and enforcement surveys that underlie this NPR and, then, to coordinate its actions with those of other regulators. This is necessary not only to eliminate CRA reliance as quickly as possible from the banking rules (most notably capital requirements), but also to ensure that the SEC's action does not create opportunities for regulatory arbitrage between broker-dealers under the SEC's non-CRA regime and banks under one that still unduly depends on CRA determinations.

> In particular, we urge the SEC to work with the banking agencies to ensure that the final version of the Basel II "standardized" approach [73 FR 43982] does not include all the CRA-based triggers in the proposal. Like the SEC's proposal, bank capital rules should reference proven credit quality and claims paying ability. Banks, like broker-dealers, can and should rely on their own credit risk and related analytics, along with proven providers of risk mitigation. Similarly, we urge the SEC to work with the new Federal Housing Finance Agency to coordinate similar changes in the capital rules now governing the housing government-sponsored enterprises.

I. Focus on Proven Forms of Risk Mitigation, Not CRA Determinations

MICA members provide primary mortgage insurance (MI), backing mortgages held by private investors and the government sponsored enterprises (GSEs). Although MICA members are state regulated, well capitalized firms, some have recently come under downgrades from the nationally recognized statistical ratings organizations (NRSROs) on which various entities, including the GSEs, base decisions on capital or approved providers of credit risk mitigation. However – and importantly – these decisions should be based on very different analytics than those related to which debt or equity investors should hold to maximize return.

Confusion between the issuer and claims paying rating has put undue stress on MICA members, hampering their ability to raise new capital to do new business at a time when mortgage market stability is critically dependent on proven forms of reliable mortgage credit-risk mitigation. We have sought to work with the NRSROs to improve the differentiation between issuer ratings and claims paying ones. This is a critical differentiation – the issuer rating provides a CRA's judgment about the long-term prospects for corporate debt, while the claims paying one is tied to the ability of a mortgage insurer to honor all its insurance commitments. While related, the capacities are inherently different because state regulation and industry practice requires provisions – e.g., a contingency reserve comprised of half of new premium revenue – to handle claims under even catastrophic scenarios. Even a troubled MI in "run-off" has ample resources with which to honor its claims.

MICA's members strongly believe that investor and regulatory judgments based on review of claims paying capacity – as evident by MI capitalization – justifies ongoing reliance on regulated MI as a form

of credit risk mitigation for purposes of setting factors such as eligible investments or regulatory capital. Indeed, we would note that one NRSRO (Standard & Poor's) noted in passing[2] that MICA members have AAA-rated capital even as it proceeded to downgrade firms based not on their capacity to pay claims, but rather on subjective judgments about the long-term prospects for the industry. This is an area of interest, of course, to corporate investors and other parties, but it is not one on which SEC or other regulatory determinations should be based.

II. Liquidity-Risk Requirements

MICA also supports the additional liquidity risk provisions in the NPR, which are a critical supplement to an independent, non-CRA dependent focus on credit risk. Off-balance sheet risk-transfer structures – e.g., letters of credit, guarantees – conducted without adequate capitalization by institutions lacking stress tested claims paying ability has been a critical part of the current crisis.

When a regulated institution faces a sharp increase in capital because of CRA failings, asset fire sales along the lines of those recently observed in financial markets ensue. These can create serious liquidity problems that lead to failures of otherwise sound institutions, resulting in potential systemic risk such as those evidenced at Bear Stearns. Adverse macroeconomic impact also results because institutions are suddenly unable to support customer demand for credit or to provide counterparty services essential to an orderly market. Capital recognition should result from proven, capitalized claims paying ability, not CRA determinations. Thus, MICA strongly endorses the proposed changes to broker-dealer net capital rules, including the new focus on liquidity risk.

To be sure, quick action is needed to implement the Basel liquidity risk standards on which MICA has favorably commented.[3] However, the SEC's proposal is also a critical element in the necessary revamp of liquidity risk management and analysis.

III. Other Regulators

Congress has instructed the SEC to work with other regulators to reduce all regulatory reliance on credit ratings agencies.[4] The first step in doing so is, of course, finalizing the NPR to set the template for how one agency reforms its practice. Once the SEC has set its course,

[2] Standard & Poor's Ratings Services, *press release* April 8, 2008.
[3] *Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee, June 17, 2008.
[4] 15 U.S.C. 78o-7.

however, it should quickly act on Congress' instructions and coordinate with other agencies to ensure comparable, quick efforts to reduce CRA reliance in eligibility, capital and similar rules.

In this regard, we note the degree to which the bank regulators rely on CRA determinations in the Basel II standardized NPR cited above. The regulators have asked for comment on this point, and MICA urges the SEC not only to make public comment on this issue, but also to work with the agencies to ensure they are fully apprised of all of the analytical work – including the background enforcement actions evidencing serious methodological problems at the CRAs.

We also urge the SEC to undertake comparable outreach with the FHFA. Currently, a wide array of requirements applicable to Fannie Mae, Freddie Mac and the Federal Home Loan Banks is CRA-based. These include the eligibility requirements Fannie Mae and Freddie Mac use to select providers of credit-risk mitigation and the risk based capital rules applicable to the housing GSEs.[5] As large, sophisticated institutions, all of the housing GSEs should be more than capable of making independent analytical judgments about credit and liquidity risk.

It is vital that the banking agencies and FHFA quickly follow the SEC's lead to ensure that the market stability benefits of the SEC's NPR are more widely established and, thus, better implemented and longer lasting. However, any divergence in practice among the regulators – especially with regard to regulatory capital – could result in regulatory arbitrage. In other words, entities could select charters or housing risk in different types of on- or off-balance sheet obligations to take advantage of more generous risk based capital based on erroneous CRA ratings reflected in one or another agency's requirements.

Chairman Cox has recently commented on the need for better uniformity in the capital and risk management frameworks for commercial and investment banks.[6] This point is also a critical element in the Treasury "blueprint" for a more robust U.S. financial-regulatory framework.[7] Indeed, the risks resulting from regulatory capital arbitrage are all too evident throughout the financial system – one need look, for example, only at the erroneous capital treatment for

[5] OFHEO Risk-Based Capital Regulation, 12 C.F.R. 1750 (2008), and FHFB Capital Requirements for Home Loan Banks, 12 C.F.R. 932 (2008).
[6] U.S. Senate Banking Committee hearing entitled: *Recent Developments in U.S. Financial Markets and Regulatory Responses to Them*, July 15, 2008.
[7] *Blueprint for a Modernized Financial Regulatory Structure*, U.S. Treasury Department, March 31, 2008.

commercial and investment bank structured investment vehicles (SIVs).

Conclusion

MICA would like again to thank the SEC for its leadership in the area of CRA reform and urge quick action to finalize the NPR. We then hope the SEC will quickly coordinate with the bank regulators and FHFA to win comparable changes in capital and related rules of all of these agencies so that financial markets can more quickly be brought back to the stability only possible when credit-, liquidity- and operational-risk judgments are based on proven risk mitigation, not untested, conflicted CRA determinations.

Sincerely,

Suzanne C. Hutchinson