Mortgage Insurance Companies of America

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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549–1090

RE: File No: 4–622

Dear Ms. Murphy:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on the request for views[1] issued by the Securities and Exchange Commission (SEC or the Commission) to implement Section 939(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] ("Dodd-Frank Act"). This provision of the law forms an important part of a reform regulatory framework for credit rating agencies (CRAs), which MICA has long supported.

This MICA comment follows views filed with the Commission in 2008[3] following the SEC's initial request for views on ways to improve CRA methodology. Then and now, MICA believes it vital to ensure that the CRAs follow robust, proven and transparent methodology to assess credit risk devoid of the conflicts of interest and lax controls that so profoundly contributed to the global financial crisis.

MICA is the trade association of the private mortgage insurance (MI) industry. As such, we have a keen interest in CRA issues. MICA members hold billions of dollars in investments and are thus at risk when ratings create inappropriate market incentives that cannot be offset by the careful scrutiny our member firms apply in their investment decision-making. MICA members are also rated both as issuers (sometimes in conjunction with a parent firm) and in terms of claims-paying ability. CRA determinations have a profound impact on MICA member eligibility to

[1] Credit Rating Standardization Study, 75 Fed. Reg. 80,866 (Dec. 23, 2010).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

[3] Mortgage Insurance Companies of America, *Comment Letter on Nationally Recognized Statistical Rating Organizations*, (July 25, 2008) *available at* http://www.sec.gov/comments/s7-13-08/s71308-30.pdf.

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provide mortgage insurance to government sponsored enterprises (GSEs), as well as to offer this insurance product to other mortgage lenders and investors, which often confuse claims paying ratings with those applied by the CRAs to issuers or complex securities structures and their resulting credit risk.

We support reduced reliance on CRAs as required by Section 939D of the Dodd-Frank Act, having experienced first hand in the run up to the crisis the risks posed when CRAs fail to anticipate demonstrable sources of growing stress in the U.S. residential finance market. However, as ratings will likely continue to be used by many global financial institutions and, at least by inference, by regulators, the SEC's inquiry and subsequent action based on it is essential.

MICA members are grateful to the SEC for the transparent process followed with regard to Section 939(h), which requires the Commission to study current CRA symbols and methodology to identify ways to improve them to ensure that rating agencies do not, as they have all too many times before, provide ratings that undermine financial market integrity and investor protection. In this comment letter, MICA will urge the following key points:

- The rating agencies should be required to differentiate ratings related to claims paying capacity, and refine the current approach where applied.

- Stress scenarios can and should be reflected in ratings. Failing to do this with regard to mortgages and MI undermined investor protection by omitting recognition of proven forms of counter cyclicality such as the contingent reserves MI firms are required to hold under applicable state regulation. In our earlier comment letters to the Commission and the banking agencies[4], MICA made clear that a serious problem with rating agency methodology prior to the crisis was reliance on limited data that did not appropriately reflect mortgage markets under stress. Had our recommendations been heeded, we believe that rating designations for mortgage backed securities (MBS), the GSEs and banks with large mortgage exposures would have been far more realistic far earlier in the business cycle.

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[4] See for example, Mortgage Insurance Companies of America, *Comment Letter on Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework*, (July 29, 2008) *available at* http://www.federalreserve.gov/SECRS/2008/October/20081031/R-1318/R-1318_4_1.pdf.

- Proven capacity to reduce loss given default (LGD), not just probability of default (PD), can and should be recognized in all CRA determinations that purport to reflect creditworthiness. Failure to do this undermines the value of proven forms of credit risk mitigation and misleads investors about likely loss. Regulatory-creditworthiness provisions such as the global bank capital requirements mandate consideration of LGD and SEC standards for CRAs should do the same.

- MICA opposes reliance on market-based indicators of PD and/or LGD, as ratings should recognize only proven ways to reduce LGD like MI and not temporary market prices that are influenced by phenomena with no link to long-term credit risk (e.g., short selling of certain instruments that affect market spread for reasons wholly unrelated to credit risk). Regulatory standards for CRAs, which MICA supports, should reflect prudential factors like capital at risk, not market phenomena with an unproven and unreliable history as predictors of credit risk over time.

- There should be separate ratings for traditional MBS versus structured finance instruments, consistent with MICA's comments in 2008. Failure to differentiate ratings for structured finance would repeat past history, in which certain structured instruments were represented as largely consisting of a single asset class or risk bucket, but in fact resulted in very different risk. All positions directly or indirectly related to structured finance by insiders (e.g., issuers, underwriters) should be disclosed in conjunction with issuance and reflected in these structured finance ratings.

- The SEC should play a strong role in CRA governance to ensure ongoing compliance with best practice. The systemic role of CRAs and proven internal control and conflict problems make clear that self-governance will quickly prove inadequate.

With regard to all of these recommendations – perhaps most especially the last – we urge the SEC to be mindful of the history of CRA conflict, methodology errors and governance failures that so grievously contributed to the global and U.S. financial crisis. These have been amply discussed in the series of hearings leading to the Dodd-Frank Act and the subsequent sessions held by the Financial Crisis Inquiry Commission.[5] Based on this evidence, the Commission must ensure a robust CRA framework going forward to correct the manifest errors in CRA process, procedure and conclusions, ensuring that the SEC sets standards for the rating agencies to promote investor protection and financial market integrity. Failure to do so will provide dangerous seeds for renewed systemic risk, especially as the SEC has yet fully to implement all of the new requirements in the Dodd-Frank Act and, upon the establishment of the new regulatory framework, ensure it is both operational and proven under stress. Rules can be revised once industry practice is demonstrably improved. However, the damage done by unregulated CRAs cannot be reversed after the fact, as is all too obvious in hindsight.

I. CRA Determinations Should Differentiate Issuer Ratings from Claims-Paying Ones and Base Claims-Paying Ratings on Relevant Criteria.

MICA is pleased to respond to Question 1(e) regarding the value of differentiated ratings, with particular attention to ratings based on the claims-paying ability of insurers. We have long worked with the nationally recognized statistical rating organizations (NRSROs) to urge that the NRSRO approach to mortgage risk is prudent, forward looking and appropriately takes into account capital and other critical risk management concerns. We have frequently found that the NRSRO approach to rating mortgage instruments is seriously deficient – for example, with regard to the credit risk associated with second liens in “piggyback” mortgages, where the NRSROs vastly underestimated a risk that roiled the mortgage markets.

Further, ratings of MBS have generally failed to take into account the value of MI as a provider of first-loss protection as a capitalized credit risk enhancement. The value of this credit risk mitigation is demonstrated in the current crisis. U.S. mortgage insurers, as of the third quarter of 2010, have paid $20.8 billion in claims and receivables to Fannie Mae and Freddie Mac, equivalent to over 13 percent of the $152.8 billion so far provided to them by the Treasury.

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[5] See for example, House Financial Services Committee, “*Approaches to Improving Credit Rating Agency Regulation*,” (May 19, 2009) *testimony available at* http://financialservices.house.gov/hearings/hearingDetails.aspx?NewsID=1269; Senate Banking Committee, “*Hearings Examining Proposals to Enhance the Regulation of Credit Rating Agencies*,” (Aug. 5, 2009) *testimony available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=89e91cf4-71e2-406d-a416-0e391f4f52b0; House Financial Services Committee, “*Reforming Credit Rating Agencies,”* (Sept. 30, 2009) *testimony available at* http://financialservices.house.gov/hearings/hearingDetails.aspx?NewsID=1127; Senate Permanent Subcommittee on Investigations, “*Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*,” (Apr. 23, 2010) *testimony available at* http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=5f127126-608a-4802-ba77-d1bdffdfbe9b; Financial Crisis Inquiry Commission Hearing: “*Credibility of Credit Ratings, the Investment Decisions Made Based on those Ratings, and the Financial Crisis*,” (June 2, 2010) *testimony available at* http://www.fcic.gov/hearings/06-02-2010.php.

Absent reliance on MI, the cost to taxpayers of the GSEs would be even higher. Had the GSEs and their ratings and regulatory framework rightly recognized the value of capital at risk in a first-loss position ahead of the crisis, MICA believes that the costs of the crisis to the U.S taxpayer would have been considerably lessened.

With specific regard to ratings of mortgage insurers, there has been considerable confusion within the NRSROs on the differences between an issuer rating – which should pertain solely to the default risk associated with corporate obligations – and claims-paying ability – which should focus on long-term capital adequacy that ensures the ability of a provider of credit-risk mitigation to honor its commitments. CRAs should be required to refine their claims paying ratings for insurers to reflect the significant differences between the accounting treatment applicable to insurers and that generally applied to publicly-traded companies under generally accepted accounting principles (GAAP). For example, MIs are required to hold premium-deficiency reserves – that is, a reserve required by auditors when premiums are deemed insufficient to honor all claims. To date, external auditors have generally approved MI premium deficiency reserves, but several MIs have nevertheless been downgraded by one or another CRA, who suggested that the insurer did not have adequate reserves to pay its claims. In such instances, the losses under GAAP accounting did not reflect statutory accounting involving releases from the MI's contingency reserves. The CRAs are entitled to independent judgment, but they can and should disclose why they have differed with applicable accounting requirements for a critical factor such as reserves established to ensure claims paying capacity.

Additionally, extraneous factors, germane only to an issuer rating (if at all) have adversely affected claims paying determinations. Several of the NRSROs have even publicly opined on the merger and acquisition prospects for MI firms – an issue very far afield from appropriate, disciplined credit-ratings determinations. In the course of the current financial crisis, U.S. mortgage insurers have continued to honor all valid claims and added additional capital to their claims paying capability. This clear distinction between issuer ratings and claims paying ones is thus validated under extreme stress conditions for the U.S. private mortgage insurance industry and this should be reflected in any changes made by the SEC or recommended to Congress with regard to CRA symbols and/or methodology following this study.

Finally, to ensure the value of claims-paying ratings and to enhance investor understanding of them, the terminology used by CRAs for claims paying ratings should be differentiated from that used for issuers or structured finance instruments. Metrics on which claims-paying ratings are based should be transparent and disclosed. At the least, they should include the ability of an insurer to honor claims under a specified stress scenario (see below), without reference to the risk that may be germane to an insurer in any other corporate capacity.

II. Stress Scenarios Can and Should be Reflected in All CRA Determinations

In Question 2(e), the Commission has asked for views on whether CRA methodology should mandate stress testing and, if so, how this should be standardized. MICA urges the Commission to mandate such tests and respectfully submits views on this question below.

The recent financial crisis – indeed, the continuing one in the European Union – have all too clearly proved the critical importance of stress testing in the determination both of creditworthiness and claims paying capacity. When stress tests are robust – as was the case in early 2009 when the Federal Reserve in the U.S. stipulated a test for large banks[6] – a clear judgment of resilience is provided. When this is not the case, as was true with the weak stress tests applied by European regulators during the summer of 2010[7]– risk determinations are not only of little real value, but can also prove misleading. It is for this reason that the Federal Reserve late last year refined its stress tests to incorporate new factors[8].

The Federal Reserve's stress tests address both idiosyncratic and market factors, the model MICA recommends be adopted also for the CRAs. Standard assumptions should be applied to all claims paying insurers, asset classes and issuers for factors germane to them (e.g., leverage ratios, loss reserves, etc.), with these idiosyncratic factors then judged in the broader context of market events such as various unemployment scenarios and house price appreciation or depreciation. The stress scenarios used to evaluate claims paying ability should be published and should reflect actual economic events. For example, if a stress scenario involves house prices declining a fixed percentage over a set period of time and these events occur, then the stress scenario

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[6] Board of Governors of the Federal Reserve System, *Agencies to Begin Forward-Looking Economic Assessments*, (Feb. 25, 2009) *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20090225a.htm.

[7] Andrew MacAskill, *EU Stress Tests May Be `Missed Opportunity' to Fortify Banks*, Bloomberg L.P., (Jul. 26, 2010), *available at* http://www.bloomberg.com/news/2010-07-26/eu-stress-tests-may-be-missed-opportunity-to-fortify-banks.html.

[8] Board of Governors of the Federal Reserve System, *Agencies Federal Reserve Issues Guidelines for Capital Action Proposals by Large Bank Holding Companies*, (Nov. 17, 2010) *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20101117b.htm.

should not involve a simple repeat of this scenario, but should instead reflect likely changes in resulting economic behavior. MICA would be pleased to provide the Commission with more information on the specifics of stress testing we believe germane to mortgage insurance companies in the U.S. for determining their claims paying capacity, for mortgage related assets and for any structured finance instruments based on mortgage assets.

Like the banking agencies, the SEC should play a strong role not only in stipulating ongoing stress tests that are updated as idiosyncratic and/or market factors change, but also ensure CRA compliance with these criteria and provide useful disclosures of test results. Criteria for CRA stress tests must be clear and consistent with SEC standards for idiosyncratic and market stress factors. Prior experience with both rating agencies and other financial institutions makes clear that supervisors must set parameters to ensure rigorous, realistic stress testing.

Further, CRAs should be required to disclose the PDs and LGDs on which ratings are based under the stress scenarios used to determine creditworthiness ratings. This is consistent with bank-regulatory practice, which generally requires banking organizations to calculate risk based capital to set confidence levels, and the SEC could insist on these levels as criteria for stress tests should disclosure of variable confidence levels be deemed too complex for the CRAs or too confusing for investors.

CRA determinations must not only include rigorous stress tests upon issuance, but also ensure that NRSROs continuously evaluate their stress tests, revise them to reflect new considerations and reconsider ratings in a transparent process to reflect changing conditions, including new capital raised by insurers that supplements claims paying capacity under stress. MICA would note that U.S. private mortgage insurers are among the few firms with large exposures in residential mortgage finance that have not only met their claims, but also raised new capital. The industry has one new entrant despite the mortgage crisis that has been funded with $575 million, while MICA members have raised $7.4 billion in new capital.

The need for SEC-dictated, tested and updated stress tests is warranted by more than the need to ensure that ratings accurately assess creditworthiness under the future conditions critical to investment decisions. Financial market risk is also at stake if ratings are based on limited factors known at the time of issuance or ratings determination, but that are not altered to reflect changed stress conditions as these factors can of course change dramatically, or, the initial information on which initial ratings are based could prove incorrect over time. The Dodd-Frank Act[9] rightly requires CRAs to undertake effective due diligence, hopefully improving initial judgments, but this system has yet to be implemented or tested, arguing for a broad, forward looking stress test framework for CRAs unless or until significant methodological improvements are demonstrated. Failure to ensure these stress tests, as well as other macroeconomic protections such as ratings maps, may exacerbate system risk, as recently discussed in a paper prepared by the International Monetary Fund. The author of the IMF paper notes "…it is critical to assess how credit ratings, especially that of new financial instruments, can lead to boom and bust cycles and endanger financial stability. 'Rating maps' can be a useful tool to identify such risks and stress tests can help measure them."[10]

III. CRA Determinations Should Reflect Proven Capacity to Reduce Loss Given Default (LGD) as Well as Probability of Default (PD)

In this section of our comment, we shall address Questions 1(f) and 1(h)(iii). MICA does not believe that there is any reason why CRA determinations should vary from the accepted approach to credit risk best exemplified in the global risk-based capital regime imposed by the Basel Committee of Bank Regulators[11] and U.S. regulators.[12] These take both PD and LGD into full account (along with exposure at default or EAD for traded instruments), as failing to do so can wholly mislead investors and regulators about actual risk. This can include the limited risk of certain asset securitizations where probability of default may seem large, but actual loss is minimal due to the presence of proven forms of credit risk mitigation like private MI. Conversely, investors can be at far greater risk than they may anticipate if PDs seem low, but loss upon default is grave. This so-called "fat-tail" risk has proven a profound contributor to the global financial crisis in large part because CRAs failed appropriately to consider LGD under applicable stress scenarios.

The critical importance of LGD to real investor-protection concerns and actual risk warrant that it be mandated for all ratings that purport to judge credit risk, not allowed only for some ratings at the discretion of a CRA. While MI reduces PD on loans as evidenced by studies presented recently to the SEC and other regulatory agencies regarding the Qualified

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §939 (2010).

[10] Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets*, IMF Working Paper WP/09/129, 30 (2009) *available at http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf*.

[11] Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, (2010) *available at* http://www.bis.org/publ/bcbs189.htm.

[12] Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007).

Residential Mortgage definition in the Dodd-Frank Act[13], MICA simply does not believe that a credit risk related rating has any investor value without both PD and LGD consideration and any discretion will contribute to a renewed round of arbitrage by CRAs and confusion by investors that will undermine market integrity.

If a CRA methodology is permitted to focus only on PD, a significant disincentive will be constructed to the use of credit risk mitigation such as MI, which investors may not recognize due to the complexity of ratings and possible variations among CRAs. MI and other robust forms of capitalized credit risk mitigation are in a first-loss position – that is, they contractually bear the risk of loss up to a certain level ahead of investors and often as a clear replacement for any third-party risk. Providers of credit risk mitigation have limited capacity to reduce probability of default except by refusing to insure certain assets and, when they do provide insurance, reviewing the underwriting the loans. This can and should be reflected by all CRAs in PD calculations, for example by differentiating loans with MI first liens at the same loan-to-value (LTV) ratio as those of other first liens (i.e., the piggyback loans referenced above) that have second liens in face of proven credit risk mitigation. However, if LGD is not reflected in CRAs, then the value and clear investor protection of MI and other forms of CRM will be ignored and, as a result, investors will be at considerably greater risk.

In considering LGD, CRAs should be permitted only to alter ratings on criteria determined by the presence or lack of proven forms of credit risk mitigation with capital at risk provided under robust regulatory standards. We shall discuss structured finance in more detail below, but believe that constructs intended to absorb credit risk – e.g., excess-spread accounts – proved woefully inadequate under stress, as evidenced by the dramatic loss of value and write-downs in MBS and other asset-backed securities (ABS) initially granted AAA or equivalent ratings. With specific regard to mortgages, the Joint Forum of global banking, securities and insurance regulators has rightly recognized the beneficial value of mortgage insurance over other forms of credit risk transfer (CRT) that purport to reduce LGD or lead to inferred credit-risk indicators.[14] In this paper, the Joint Forum not only urged widespread reliance on government and private MI, but also outlined an array of concerns related to CRT structures such as credit derivatives.

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[13] See October 27, 2010 letter to Mr. Jay Knight, SEC Division of Corporate Finance, regarding MICA presentation to SEC on October 5, 2010 at http://sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-6.pdf along with presentation documents that showed analysis of publicly-available data shows that insured loans became delinquent 47% less frequently, cured 54% more frequently and have performed 65% better than comparable piggyback loans available at: http://sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-6.pdf.

[14] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation*, 17 (2010) *available at* http://www.bis.org/publ/joint24.pdf.

The SEC is of course working with other regulators now to implement reforms to the credit-derivative arena mandated by the Dodd-Frank Act.[15] We urge that CRA consideration of the value of credit derivatives as a form of credit risk mitigation reducing LGD be deferred until this new regulatory framework is completed, implemented and tested. Our concerns with regard to credit derivatives are heightened by recent trading patterns related to some instruments, which are discussed in more detail below with regard to the SEC's question about use of market-spread or similar data as a criterion for credit ratings.

Reflecting the importance of investor understanding, MICA has filed a letter generally supporting the SEC's proposal to require disclosure of MI and similar forms of credit risk mitigation for residential MBS,[16] but we think these disclosures – likely very complex – must be supported through ratings that fully reflect credit risk to investors.

IV. CRA Determinations Should be Based on Proven Credit-Risk Factors, Not Market Spreads or Structures

Question 3(d) in the SEC's request seeks views on the use of market spreads as an indicator of credit risk. MICA strongly opposes this, based on the proven, disastrous history of these factors as indicators of credit risk in the current financial crisis. As many histories of the U.S. mortgage crisis have demonstrated,[17] risk spreads demanded by the market for MBS were wholly unreliable. They all too often were determined by short-term phenomena, such as the relative demand for certain instruments based on trading or other factors with no bearing on investor protection. Spreads related to credit default swaps (CDS) proved particularly unreliable, since CDS quickly became traded instruments with at best uncertain assignment to a counter party with proven capacity to honor claims. Thus, a 2010 study found that CDS may be a "useful analytical tool," but that they can impose "significant costs on market participants" due to factors such as volatility and false positives under stress.[18] Further, studies have found that CDS spreads factor numerous other non-default risk considerations into their risk pricing. For example, a 2010 Federal Reserve Board Working Paper concluded, "Empirical research also shows that in practice, CDS spreads contain compensation for non-default risks as

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[15] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111 203, TitleVII, (2010).

[16] Mortgage Insurance Companies of America, *Presentation to SEC by MICA on October 5, 2010*, *available at* http://sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-12.pdf.

[17] See for example, Bethany McLean and Joe Nocera, *All the Devils Are Here: The Hidden History of the Financial Crisis* (2010), Michael Lewis, *The Big Short: Inside the Doomsday Machine* (2010), Gregory Zuckerman, *The Greatest Trade Ever: The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History* (2010).

[18] Robert J. Grossman & Martin Hansen, *CDS Spreads and Default Risk: Interpreting the Signals*, Fitch Ratings Special Report, *at* 8 (2010).

well as risk premiums which may be difficult to identify without the aggregate macro variables."[19]

The problem with reliance on market spreads is exacerbated by the wide variation in the ways they may be calculated. The SEC's request for views cites one possible option– "Merton type models which provide a distance to default measure based on equity prices." However, as the Commission reflects in its questioning, this is just one approach to identifying factors that may reduce LGD or predict PD. Many financial institutions and CRAs have their own models that may or may not be based on widely accepted standards for model integrity or be subject to the rigorous back-testing, conflict-of-interest and related standards mandated by the banking regulators for the limited models authorized for use under the internal ratings based options in the Basel II and Basel III rules cited above. Recent studies have shown wide variability among these different models based in part on model criteria and also on the way they are then deployed for different configurations of credit risk in different types of financial institutions. For example, a paper assessing CDS as an indicator of market pricing and risk at German banks found widely different results based on a bank's business model, concluding that equity prices and other variables are required to make CDS a meaningful predictive factor. [20]

Worse still, the crisis has demonstrated a clear correlation between market spreads and CRA determinations, making these self-reinforcing factors that would prove, at best, unreliable risk indicators prone to profound conflicts of interest. The literature cited above and numerous academic paper note that market demand for complex structured instruments and private-label ABS was in large part driven by CRA determinations. Where a AAA or equivalent rating was granted, market demand was strong and spreads were small even though, as recent history has demonstrated, CRAs were poor predictors of creditworthiness. Absent ratings, market spreads or similar factors might arguably be useful risk determinants assuming all of the trading concerns cited above are addressed and model-driven differences reconciled. However, if ratings depend on spreads, then each will drive the other in a manner wholly opaque to the markets and of limited, if any, value to investors as a guide to PD and LGD. As a result, market spreads and similar factors should not be recognized as a way to signal or, worse, mitigate credit risk.

V. Structured-Finance Instruments Must be Differentiated from Clear, Transparent Securitization Structures and Other Asset Classes

[19] Hao Wang, Hao Zhou, and Yi Zhou, *Credit Default Swap Spreads and Variance Risk Premia*, Federal Reserve Board Working Paper 2011-2, *at* 7 (2010).

[20] Klaus Düllmann and Agnieszka Sosinska, *Credit Default Swap Prices as Risk Indicators of Listed German Banks*, Financial Markets and Portfolio Management, Volume 21, Number 3, 269, (2007).

In this section, MICA addresses the question in 1(h)(v), which deals both with the need for variations in ratings for asset classes and the specific need for separate rules to differentiate structured finance instruments from other ratings categories. One major problem in structured finance has been reliance on excess spread or similar fee based forms of credit enhancement instead of proven forms of capitalized credit risk mitigation provided by regulated firms (such as private mortgage insurers). Because these forms of credit risk mitigation are backed by hard capital committed to make investors whole, they can be initially more costly than alternatives, creating an incentive for structures that may well leave investors with unanticipated credit losses ,which was the result of previous structured finance arrangements in the private label mortgage arena.

CRAs should thus be required to use separate symbols to differentiate such ratings. MICA believes the ease with which AAA or equivalent ratings were granted to senior tranches in high-risk structured mortgage obligations that relied on unproven forms of credit risk mitigation (if any) was very inappropriate. These AAA designations led investors to conclude that these tranches were the risk equivalent of MBS backed by the express guarantees of the U. S. Government or the government sponsored enterprises, diverting capital from prudent mortgage securitization into high-risk assets now posing profound systemic risk.

Perhaps worse, many collateralized debt obligation (CDO) instruments and CDO squared and similar arrangements based on them were represented by issuers as consisting of a single asset class, but in fact held other and often far riskier ones. The hearings noted above in footnote 5 include detailed testimony regarding the structures represented by issuers as consisting principally of low-risk assets like highly-rated corporate obligations that in fact included as much as a majority of subprime MBS. Asset class ratings alone may not well capture this because investors may not fully understand that asset-class determinations may be based on only a percentage of actual assets in an instrument. A separate scheme for structured finance is thus essential to ensure that investors look behind the ratings and/or asset-class representation to understand the nature of the structure in an instrument and the position the investor may take in a waterfall or similar risk structure.

Structured-finance instruments also provide particularly strong incentives for issuers, underwriters or others involved in the securitization and structuring process to take positions at conflict with those of investors. Again, the hearing testimony – most particularly that of the Senate Permanent Investigations Subcommittee with regard to the Goldman Sachs Abacus transaction[21]– demonstrated that parties could ostensibly be

[21] Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, "*Wall Street and the Financial Crisis: The Role of Investment Banks*", (April 27, 2010).

taking a "risky" position such as an equity tranche even as they secretly "shorted" this risk. Disclosures associated with structured finance and all ratings related to them must be based on a clear understanding of all positions taken by insiders in these instruments so that investors are guided to the real risk they may run without false hope that a "sophisticated" investor or underwriter is in a first-loss position ahead of them.

We believe that all of these structured finance requirements should be stipulated by the Commission and issued by rule, not through additional disclosure requirements or industry self-imposed standards. MICA is concerned that CRAs could attempt to comply with the requirements by using only reports that, if too long and/or complex, could become the equivalent of prospectuses often ignored by investors in favor of simple ratings symbols. Thus, should the Commission decide not to mandate separate ratings symbols for structured finance, but instead to permit reports, MICA suggests that the final rule be clarified to mandate that any such reports be clear and as short as possible, with clear conclusions that guide investors to key default risk differences for structured finance clearly identified in a conspicuous statement summary at the outset of any such report.

VI. The SEC Can and Should Govern CRA Standards, Not Rely on Private Initiatives

Question 1(h)(vi) seeks views on the governance that should apply to new CRA standards. MICA urges the SEC to play a direct role in establishing standards and ensuring compliance with them for new CRA methodology and symbology. The Dodd-Frank Act has not only clearly provided the Commission with authority to do so, but also mandated a new Office of Credit Ratings[22] to do so. We believe that this new Office will fall short of its Congressional mandate and that the Commission would sow the seeds for another rating agency systemic risk should it defer to the rating agencies in this critical arena.

Institutional investors have called the rating agencies "financial gatekeepers with little incentive to 'get it right,'' concluding that this "poses a systemic risk."[23] As the Commission knows, Section 120 of the Dodd-Frank Act requires the Financial Stability Oversight Council (FSOC) to consider which "activities" and "practices" could pose systemic risk and, then, to demand that primary regulators take appropriate action. Ratings have proven so profound a causal factor in the current global crisis that we think it beyond doubt that CRA

[22] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932 (2010).

[23] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, *at* 3 (2009) *available at* http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf.

methodology and symbols, as well as their use by investors and regulators, are an ongoing systemic risk. Absent immediate SEC action in this area, FSOC should deem ratings designation a systemic practice and mandate express criteria and disclosures along the lines recommended above.

Conclusion

MICA has long advocated significant reform to the methodology of rating agencies with regard to claims-paying capacity for mortgage insurers and to credit risk associated with mortgage related instruments, doing so in the comment letters cited above and many others to the Commission and federal banking agencies. Our concerns were proven to be correct as poor methodology, conflicts of interest, insufficient disclosure and undue reliance on ratings contributed to the global financial crisis and the U.S. macroeconomic decline, including steep unemployment that exacerbates financial market stress. If all of the reforms to CRAs mandated by the Dodd-Frank Act are to have their desired effect, the SEC must set clear, transparent and enforceable standards for ratings that highlight different risk profiles resulting from factors such as the ability to pay claims (versus to avoid insolvency), reflect the critical importance of judging credit risk under stress scenarios stipulated by the Commission, mandate consideration of LGD in all credit risk-related ratings, bar use of market factors as a ratings criterion and separate ratings for structured finance instruments from all others. To ensure that this new framework is meaningful over time, the Commission should govern it, not rely on self regulation or private entities to do so.

MICA would be pleased to provide the Commission with additional data or other assistance as it studies ratings agency symbols and methodology, working towards a new regulatory framework to prevent a repeat of past history once the "coast is clear."

Sincerely,

Suzanne C. Hutchinson