

Submission by
Genworth Financial – Mortgage Insurance Europe
in Response to the Norwegian FSA's Consultation
Paper on the Draft Capital Adequacy Regulations
dated 28 April 2006

The Consultation Paper [CP] on the Capital Adequacy Requirement for credit institutions etc. (Forskrift om kapitalkrav for finansinstitusjoner, oppgørelse-sentraler, verdipapirforetak og forvaltningsselskaper for verdipapirfond) (the “Regulations”)

1. General Comments

Genworth Financial Mortgage Insurance Europe [GFMI Europe] welcomes this opportunity to comment on the Norwegian FSA’s [NFSA] Consultation Paper on the capital adequacy requirement for credit institutions and we look forward to further dialogue on the issues that we raise in our response.

It is important that, as the regulatory framework is adjusted to reflect the historically lower risk of residential real estate assets, incentives to lend and to manage risk prudently are maintained across the banking system. Our comments are intended to assist the NFSA in achieving this objective.

As a leading global provider of residential mortgage insurance, GFMI Europe has a keen interest in understanding how the Capital Requirements Directive [CRD] will be implemented in Norway and more specifically how it will affect residential mortgage finance and the lenders involved in this activity.

Mortgage lending is traditionally viewed as one of the safest forms of lending, despite the cyclical nature of the value of residential property. However, whilst it is true that these assets generally exhibit a lower risk due to the underlying security attached to the loan, experience demonstrates that, over the full economic cycle, high loan to value (LTV)¹ lending represents a significantly riskier portion of the mortgage lending market. Therefore, it is critical to ensure that the capital held for high LTV mortgages is sufficient to cover this increased risk and ensure that lenders fully understand how these mortgages act in a stress environment. In addition, a sophisticated risk-based framework should ensure that incentives exist for the effective management of the credit risk arising from mortgage lending. However, in our view, it is imperative that, in order to protect the soundness of the banking system as a whole, the capital held against the risk of these mortgages must truly reflect the economic risk of this form of lending. GFMI Europe continues to be concerned that the actual capital requirements proposed might fall short of achieving this.

In light of the focus of our business, our comments concentrate on those areas that are relevant to mortgage lending, from the perspective of the origination of residential mortgage loans and the use of credit risk mitigation techniques. In particular we have provided comments on the following areas:

¹ Please note that the term LTV is used throughout this response for simplicity, although we are aware that in Germany lenders refer to loan to appraised value (LTAV).

2. Technical Comments

Risk Weighting for high LTV mortgage loans

The Capital Requirements Directive introduces a concessionary risk weight of 35% for exposures secured by mortgages on residential property.² One of the requirements for the application of the concessionary risk weight is that *the value of the property exceeds the exposure by a substantial margin*.³ We understand that in Norway the 35% risk weight would apply to loans with LTV up to 75% (60% for “fritidseiendom”).⁴ However, it is unclear how high LTV loans will be treated under the new capital rules, and whether a higher risk weight will be applicable only to the top portion of the high LTV mortgage loan (i.e. the portion above 75% LTV) or whether a higher risk weight will be applied to the whole loan. In this respect we would refer to the CRD, which states that exposures fully secured by real estate property shall be assigned a risk weight of 100%.⁵ (Annex VI, Part 1, paragraph 44).

The CRD provisions recognise that not all mortgage loans constitute a low risk form of lending and that high LTV mortgage loans experience higher probability of default and higher loss severity. The application of a 100% risk weight on the high LTV portion of a mortgage loan is being supported by other national regulators, e.g. in Italy and Ireland. IFSRA (the Irish Regulator) has recently announced that it intends to commence requiring lenders to apply a 100% marginal risk weight to the portion of a residential mortgages above 80% LTV from 1st May 2006.

High LTV mortgages perform appreciably worse than lower LTV mortgages, particularly during economic downturns.⁶ In a benign economic environment, high LTV mortgages perform consistently worse than lower LTVs. However, during periods of economic recession, or times of housing market stress, the default rates of high LTV mortgages increase exponentially. Figure 1 below shows mortgage default rates by LTV over a 25-year period. The trend of higher LTVs performing worse is common across all years.

By segmenting the total high LTV portfolio into several smaller bands, it can be seen that the differences in default rates are accentuated. Whilst there is a similar pattern across economic cycles, i.e. defaults increase as the LTV increases, the magnitude of this difference changes. Unsurprisingly, the 97% LTVs show the highest default rates, with the rate reaching a peak of almost 1 in every 4 loans. By comparison, the average rate for all LTVs over 80% was 1 in 9. During a recession that followed the origination of these loans, 6 times more 97% LTV loans defaulted than 80-85% LTV loans.

² Directive 2006/48/EC Annex VI, Part 1, paragraph 45.

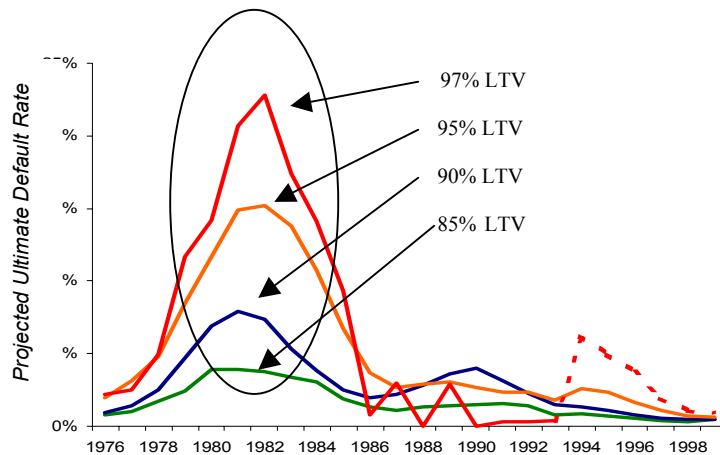
³ Directive 2006/48/EC Annex VIII, Part 1, paragraph 48(d).

⁴ Regulations Part III § 2-10 (a and b).

⁵ Directive 2006/48/EC Annex VI, Part 1, paragraph 44.

⁶ When illustrating the changing nature of different LTV bands in both normal and stress environments, it is helpful to look at historic performance data. For this purpose, we have used data on UK and US mortgages as a benchmark. Both the UK and US mortgage markets are cyclical in nature and the magnitude of change in the rate of default in a stress environment is common to both markets. However, data from the US is a much richer source as it goes back many years and is more readily available than in other markets.

Figure 1: LTV Performance Over Downside Cycles



Source: Mortgage Insurance Companies of America (MICA) (US), Total US Market Experience. More information on MICA is available on <http://www.micanews.com/>

We suggest that a 100% risk weight be applied to the top portion of a loan, i.e. the portion above an LTV of 75% (60% for “fritidseindom”).

Use of Original Rather Than Current LTV And Valuation of Underlying Mortgage Collateral

A further important consideration when assessing the risk of high LTV loans is the use of original rather than current LTV. We believe that, when determining capital requirements, lenders should refer to the LTV as calculated at origination.

We have identified 3 major concerns with the use of current LTV:

1. LTV plays an important role in assessing credit risk, and this role would be diminished by allowing the use of current LTV to determine capital requirements. The adjustment to a lender's mortgage portfolio based on current LTV, where house price appreciation has been high, would lead to an inappropriate reduction in the relative Probability of Default (PD) of a portfolio and a consequently inappropriate reduction in capital requirements.

Our analysis demonstrates that the PD increases for all mortgages in the first four years from origination.⁷ Furthermore, in general, foreclosed properties are those which the borrower has been unable to sell at a price which would enable the repayment of the outstanding balance of the loan. Analysis of UK mortgage portfolios indicates that a key driver of overall PD rates is a high concentration of properties in areas where values are generally low and that are

⁷ Based on an analysis of UK mortgage portfolios.

undesirable. This implies that, for those borrowers likely to default, the Loss Given Default (LGD) is unlikely to be reduced by house price appreciation, even where property values in general have increased. Therefore, the use of current LTV will consequently lead to an underestimation of the LGD on future foreclosures. In addition, if the recovery value of foreclosed properties in a given year of origination declines as the general market value increases, the recovery value as a % of general market value declines in real terms.

2. The rationale for using current LTV ignores the fact that long-run house price appreciation is already included in the assumptions currently used in the calculation of capital requirements under the original LTV approach. Consequently, use of current LTV may lead to an element of double-counting for capital calculation purposes, and may also call into question future use of historical data based on original LTV.
3. Use of current LTV may introduce an element of procyclicality into capital calculations by allowing the reduction of capital requirements in periods of high house price appreciation, placing lenders in the position of needing to increase capital levels in ensuing periods of house price deflation, at a time when increasing default levels means that they can least afford to do so. This effect is even more pronounced when considering the current growth in the market of “interest-only” mortgages, which do not amortise over the life of the loan. By allowing lenders to take house price appreciation into account, the regulator would, in effect, be allowing a marking to market of the capital requirements, which would lead to an underestimation of the capital actually required and the introduction of volatility in the actual levels of capital held.

We suggest application of original rather than current LTV

The treatment of non-conforming mortgages

We understand that the CP does not contain explicit references to non-conforming mortgages⁸ and it is possible that, unless the position is clarified, lenders may be able to apply a 35% risk weight under the RSA to this form of lending.

In our view, a 100% risk weight should be applied to the whole loan. The CRD states that, when deciding whether to apply the 35% risk weight, “...*the lender must consider whether the value of the property does not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macroeconomic factors affect both the value of the property and the performance of the borrower.*”⁹

In our view, where a non-conforming mortgage is granted to the borrower, macroeconomic factors may have an impact on the performance of the borrower. In these cases, it is arguable that the

⁸ We would define non-conforming mortgages to include products such as buy to let sub-prime and self-certification mortgages.

⁹ Directive 2006/48/EC, Annex VI, Part 1, paragraph 48.

requirement above is not met, and therefore it is not appropriate to apply a 35% risk weight. In particular, our analysis of the economic capital requirements for the non-conforming mortgage sector suggests that a risk weight of almost 150% would be appropriate for 100% LTV non-conforming mortgages.

The Australian Prudential Regulatory Authority (APRA) has also raised concerns regarding non-conforming mortgages and confirmed in 2004 that the current 50% Basel I risk weight for residential mortgages should only be applied where the lender has adequate procedures to gauge the ability of the borrower to meet repayment obligations and to independently assess critical information in respect of the borrower. In particular, APRA was keen to ensure that the review of the appropriate risk weight for residential mortgages addressed the likelihood of increased risk in certain types of non-conventional lending. As a result, all non-conforming mortgages are now subject to a 100% risk weight against the whole loan.

We would be interested in understanding the NFSA's position with respect to non-conforming mortgages. In respect of such products, we suggest that 100% risk weight should be applied to the whole loan.

Treatment of past due items

The CP does not seem to contain any provisions on the treatment of past-due items [reference is made to Annex VI, part 10, para 58 – 62 of the CRD].

Considering the distinction introduced by the CRD between the secured and unsecured portion of past-due items,¹⁰ and the implication that such a distinction has in terms of different risk weights, we are unclear what risk weight should be applied to the portion of a mortgage loan above 75% LTV.

We believe that the high LTV portion of a mortgage loan should be treated as unsecured when it becomes past-due, and therefore would be subject to a 150% risk weight where the value adjustment is less than 20% of the unsecured part of the exposure.

When considering provisions on this, we would also urge the NFSA to consider the effect of CRM in this context. We are concerned that the CRD suggests that CRM should be considered in the abstract, whereas, in practice, CRM should be considered in conjunction with the underlying asset due to the direct consequences for the treatment and calculation of past due items. We believe that if credit risk mitigation is provided over the mortgage, so that, in fact, no part of the mortgage should be deemed to be “unsecured” and that, consequently, the lender should be required to make only one calculation for ascertaining the applicable past due risk weight.

The basis on which CRM is recognised in relation to a performing asset is that there is a true transfer of credit risk. The nature of that effective risk transfer does not change simply because the asset has

¹⁰ Directive 2006/48/EC, Annex VI, Part 1, paragraph 61 and 64.

become past due; indeed, it is precisely when an asset becomes past due that third party risk mitigation provides the most value as an effective CRM tool.

We would be interested in understanding the NFSA's position with respect to the treatment of past due items and the impact of any forms of CRM on the adjusted risk weight applied.

Unfunded Protection – Additional Requirements for Guarantees

In the CRD, the term “unfunded credit protection” is used in Annex VIII, Part 2. However, in the Regulations Part V § 2-6, the Norwegian words for “guarantees” and “credit derivatives” are used instead. The same is true about the word “guarantee” rather than unfunded credit protection in the Regulations Part V § 1-9. We are concerned that the reference to “guarantees” and “credit derivatives” in the Regulations may introduce unnecessary confusion and restrictions in the application of the rules, which were not intended in the CRD text. In particular, it has been generally accepted that products, which act in the same way as guarantees can be recognised as unfunded credit protection and the use of this term within the CRD indicates that the term “guarantee” should be considered in its broadest sense.¹¹ However, it is not apparent that the NFSA intends to apply a similarly broad interpretation to the recognition of credit risk mitigants within the Regulations. If the term “guarantee” is intended to be used as an abbreviation for guarantees and other similar product within the Regulations, this should be noted at the outset of the section to avoid confusion.

Our suggestion: that instead of making reference specifically to “guarantees” and “credit derivatives”, reference should be made to “guarantees, credit derivatives or other forms of unfunded credit protection” where suitable.

Eligible assets for covered bonds

The Regulations does not seem to contain any provisions on eligible assets for covered bonds (reference is made to Annex VI, Part 1, Para 65 – 68 of the CRD).

We would be interested in understanding the NFSA's position with respect to eligible assets for covered bonds, especially since, in our view, the CRD text on this, with respect to loans secured by residential real property, is rather unclear.

In the CRD, it is stated that “*Covered bonds*” shall mean bonds as defined in Article 22(4) of Directive 85/611/EEC and collateralized by any of the eligible assets... loans secured by residential real estate... where only liens that are combined with any prior liens within 80% of the value of the pledged properties [plural].

¹¹ Unfunded credit protection is defined in the CRD (Article 4) as “a technique of risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the undertaking of a third party to pay an amount in the event of default of the borrower or on the occurrence of other specified events.”

In our view, there are several ways to interpret the CRD requirement.

1. The covered pool consists only of mortgages with an individual LTV ratio of no more than 80%;
2. The covered bond pool may consist of mortgages with LTVs higher than 80%, but only the first 80% is funded through the covered bond; the remainder is funded by alternative means, or used for overcollateralisation; or
3. The covered bond pool consists of mortgages with an aggregate average LTV of no more than 80%.

Further, other factors, such as the recognition of CRM products will also need to be taken into account when considering the definition of total eligible assets. For example, if a loan-by-loan approach is used, as outlined in the first point above, could high LTV loans with MI protection down to a level which generates similar PD (probability of default) and LGD (loss given default) characteristics to that of an 80% LTV be included within the pool? In addition, to the extent that the NFSA proposes an approach along the lines of that outlined in point 2 above, could the use of CRM products within a pool allow the whole loan to be used for funding purposes, rather than just the first 80%? Similarly, when considering the 80% threshold on the average portfolio basis, can CRMs be used to reduce the overcollateralisation requirement?

If a strict loan-by-loan approach is used and the benefits of CRM are not recognised under point 1 or 2, in our view, the NFSA should consider the negative effects to consumers that are likely to follow from that. Potentially, without the use of CRM, the cost for banks to continue to provide high LTV loans increase relative to the cost of funding low LTV mortgage loans through a covered bond. This increased cost would need to be passed on to borrowers, which could have potential implications for the future strength of the housing market, and could further exacerbate the problems currently faced by first time buyers. It is also possible that the legislation could lead to the growth of a “second liens” market for the portion of mortgage over 80% LTV, which tends to have less security than the traditional mortgage market.

In our view, the recognition of third party credit risk mitigation over the cover pool could address the majority of these issues, as it would mean that the LTV threshold of the cover pool could be increased without a commensurate increase in the credit risk of the pool. Rating agencies such as Fitch, have established criteria to analyse high LTV mortgages protected by credit risk mitigation. In our view, these criteria could also successfully be applied to covered bond pools, which contain high LTV mortgages. However, in order for this to be possible, the NFSA would need to provide flexibility in its approach to the definition of the total asset pool and define precisely the circumstances under which high LTV residential mortgage loans could be included and [entirely] funded through the issuance of mortgage bonds.

We would also note that this approach could also relieve the NFSA's potential concerns with regard to the potential "cherry picking" of the assets that go into the pool and would therefore reduce the risk that the highest risk mortgages are retained by the lender.

We hope that the above is useful. We would be happy to discuss in more detail any of the issues addressed in our response.

Yours sincerely,

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Stockholm, 28 August 2006

[Additional information on GFMI Europe](#)

GFMI Europe¹² is a AA rated monoline insurer¹³ whose core business lies in the provision of mortgage insurance (MI) for prime high loan-to-value (LTV) mortgages. MI is a form of credit insurance protecting residential mortgage lenders for any difference (up to a contractually agreed threshold) between the outstanding amount owed by a defaulting borrower and the amount collected in a foreclosure proceeding or in an out-of-court settlement¹⁴. GFMI belongs to the Genworth Financial group.

GFMI Europe is supervised by the UK FSA. Our affiliates in the US, Canada and Australia have over 20 years experience of providing MI in those countries. We now offer MI in seven countries within the EU from either our London office or through our local branches, and are actively seeking to expand our business throughout the EU. Other MI affiliates within the Genworth Financial group are also developing their business throughout the Far East and Mexico.

Genworth Financial is one of the largest insurance holding companies in the US, with approximately \$ 100 billion in assets and an expanding global presence. Having been a subsidiary of General Electric Company, Genworth Financial has been a publicly listed company since May 2004. Genworth

¹² Our legal name is GE Mortgage Insurance Limited (GEMI). UK FSA firm reference number: 202893.

¹³ GEMI has been "AA" rated by Standard & Poor's and Fitch Ratings and Aa2 by Moody's Investor Services since the end of 2001.

¹⁴ Our MI policy covers all losses related to borrower default: un-recovered principal outstanding, normal past due interest up to the date of the claim and reasonable recovery and foreclosure costs.



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Filename: Response Norway3.doc
Directory: C:\Documents and Settings\112002132\Local
Settings\Temporary Internet Files\OLK12A
Template: C:\Documents and Settings\112002132\Application
Data\Microsoft\Templates\Normal.dot
Title: Dear Mr Bredhe,
Subject:
Author: GNW
Keywords:
Comments:
Creation Date: 28/08/2006 10:35
Change Number: 17
Last Saved On: 28/08/2006 17:01
Last Saved By: GE Mortgage Insurance
Total Editing Time: 64 Minutes
Last Printed On: 28/08/2006 17:02
As of Last Complete Printing
Number of Pages: 10
Number of Words: 2,920 (approx.)
Number of Characters: 16,646 (approx.)