January 17, 2002

Mr. Alfred Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, N. W., Fourth Floor
Washington, D. C. 20552

Re: OFHEO's Proposal to Amend its Risk-Based Capital Regulation

Dear Mr. Pollard:

PMI Mortgage Insurance Co. is pleased to submit to you our comments on the proposed amendments to Appendix A Subpart B of 12 CFR 1750 Risk-Based Capital announced on December 11, 2001 ("Regulation").

We were encouraged to see that OFHEO is proposing to reduce the haircut differential between AA and AAA-rated mortgage insurance from ten percentage points to 5.25 percentage points, to lengthen the phase-in period for the haircut from five to ten years and to utilize recovery rates in calculating the final capital haircut. We fully support the lengthening of the phase-in period, and believe that the reduction in the AA/AAA differential and utilization of recovery rates in calculating the final haircuts are steps in the right direction. However we continue to believe that any differential in the haircut for AA and AAA-rated mortgage insurance is not supported by the pertinent data and contradicts the conclusion drawn by every other financial regulator, both domestic and international, that has considered this issue. Further, we believe that OFHEO's stress test model and not bond default studies is the appropriate proxy to be used to judge the risk of default of mortgage insurers. Nevertheless, the data in the bond default studies supports a lower assumed default rate for AA-rated counterparties and higher recovery rates, particularly for mortgage insurers. The data and logic for these conclusions is more fully described in Appendix A. In addition Appendix A contains information on why the proposed 10-year phase-in period should be maintained.

PMI recommends the following change:

> **Eliminate the differential in the haircut between AA and AAA-rated mortgage insurance for purposes of the risk-based capital regulations. This change will avoid the unintended consequences of reduced availability of mortgage insurance, a reduction in affordable housing programs, rising costs for homebuyers and**

increased exposure of the U.S. taxpayers by a change in the business practices of the GSEs and their partners if the Regulation is not changed.

In addition, the industry trade association, Mortgage Insurance Companies of America (MICA), has submitted a comment letter on the proposed amendments. MICA's letter, in addition to commenting on the capital haircuts for AA and AAA-rated counterparties, also commented on four other issues:

1. Haircuts for unrated seller/services;
2. Credit derivatives;
3. Spread accounts,
4. Structured loans; and
5. Transparency of OFHEO's model.

PMI agrees with, and endorses, MICA's comments on each of the above listed issues.

Background

PMI Mortgage Insurance Co. is one of the largest mortgage insurance providers in the United States, Australia, New Zealand, Hong Kong and the European Community with nearly $137 billion of mortgage insurance and over 1.5 million policies in force that have enabled families to achieve the dream of homeownership. Approximately 70 percent of the $108 billion in mortgages that PMI insures in the U.S. are held by either Fannie Mae or Freddie Mac (collectively "the Enterprises"). Thus OFHEO's risk-based capital regulations, specifying capital haircuts for mortgage insurance on loans owned or securitized by the GSEs, have a significant and direct impact upon PMI's business, the families who are able to achieve homeownership with the assistance of PMI's insurance, and the approximately 1,800 lenders whose needs we serve.

For over forty years, the mortgage insurance industry has been a reliable, stable, and predictable risk share partner to the mortgage finance industry, paying in full more than 99.7% of all claims. We effectively settled billions of dollars of insurance claims through the most severe real estate downturns since the Depression of the 1930's. For example, the mortgage insurance industry paid more than $6 billion in claims to its policyholders in the 1980's alone. Without our industry, the Oil Patch, New England, and Southern California real estate depressions could have threatened the viability of the Enterprises and the modern mortgage finance system. Importantly, our industry followed through on its commitment with no risk to taxpayers or support from the United States government.

The mortgage insurance industry has also been at the forefront in promoting affordable housing opportunities. PMI has a long history of providing specially developed affordable housing programs, and in total has insured over $116 billion in low- and moderate-income loans. We exist to expand homeownership opportunities for first-time homebuyers and families of modest

economic circumstances. A more detailed discussion of PMI's affordable housing activity is contained in Appendix B to this letter.

Numerous housing/mortgage market experts including the Joint Center for Housing Studies of Harvard University have forecast that upwards of one-third of all first-time homebuyers in this decade will be minorities and immigrants, as these families avail themselves of greater financing opportunities and strive to achieve homeownership rates that will approach the levels enjoyed by the U.S. population at large. These families will have demonstrated the ability to manage their finances, and will have the income to meet their mortgage and other financial obligations. Most will have savings sufficient to make at most a downpayment of 3 – 10%, and thus will require mortgage insurance to obtain a loan. Hence the cost and availability of private mortgage insurance is a very real issue for low and moderate-income families.

It is within the context of this background that we offer these comments on OFHEO's proposed amendments to the Risk-Based Capital Regulation.

Comments

We believe that OFHEO should make no distinction in the haircut differential between AAA and AA-rated mortgage insurance.

This is supported by the approach of the U.S. banking regulators, the draft Basel Accords, the rating agencies, the rating of the Enterprises, claim paying experience on mortgage loan defaults since the Depression and bond default studies in general.

i. *The default rates assumed by OFHEO in the regulation rely heavily on data from the Depression era. The available data on corporate bond default experience is less reliable for the Depression period than for more recent years, which include periods of substantial stress. It cannot be disputed that there have been profound changes in the U.S. economy generally, and the financial markets in particular, since the Depression, so that data from that period is inherently unlikely to be "consistent with the stress period," which is actually based on the economic stress experienced in several southwestern states in the early 1980s.*

Use of Depression data is not consistent with, and also contradicts, the requirements of OFHEO's enabling legislation. See 12U.S.C.4611(a) and 12U.S.C.4611(b). Considering the clear statutory requirement that the Regulation should be formulated in the light of various factors "consistent with the stress period," OFHEO's heavy reliance on Depression-era data to assign dramatically different haircuts to AAA- and AA-rated private mortgage insurers is inappropriate. If bond

default data is to be used, more recent data, including data from the early 1980s should be used and it shows little or no difference in the default rates of mortgage insurers in the top two rating categories.

ii. *OFHEO chose 1983 and 1984 as the relevant historical period for the credit risk portion of the stress test. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, provides the basis for OFHEO's stress test and requires that characteristics of the stress period not specified explicitly in the law be consistent with the characteristics of the stress period chosen as the relevant historical period. The Senate Report on the 1992 law comments on this issue directly: "The legislation deals most carefully with the projection of losses associated with mortgage defaults and interest rate changes, but other factors may have a significant effect on GSE survivability. The Director will need to explicitly consider such other factors as mortgage prepayment rates, non-interest expenses, dividend policies, fee and investment income, taxes and financing strategies. In making assumptions about these variables, the Director should endeavor to make them as consistent as possible with the interest rate and default characteristics of the stress test." Senate Report 102-282, Federal Housing Enterprises Regulatory Reform Act of 1992 (May 15, 1992), page 23. Reliance on Depression era data is not consistent with the stress test. Further, bond default studies are not an appropriate measure of the risk of default of mortgage insurers.*

In examining the Moody's data from the stress period, it shows that for the cohorts formed in 1983 and 1984, the ten-year cumulative default rates for AA cohorts were 2.0 percent and 1.8 percent, respectively. This is substantially less than OFHEO's proposed calibration of AA nonderivative counterparty haircuts to a default rate of 8.75 percent. Also, this 1983-84 stress period experience shows that parity of AAA and AA default rates is the most reasonable calibration of the OFHEO counterparty haircuts. For the 1983 and 1984 cohorts, the cumulative ten-year default rates for AAA cohorts actually were slightly higher than the AA experience (2.7 percent and 2.1 percent, respectively). (Source: Moody's Jan. 1997 publication, "Historical Default Rates of Corporate Bond Issuers, 1920-1996").

The Depression era bond default data pertains to a period with a significantly different industry mix of bond issuers than the present. Actual default rates from the Depression period were dominated by issuers from the transportation sector, whereas the current economy—and the GSE's counterparty risk profile—is much more oriented toward financial firms and financial instruments.

Even with the proposed amendments, the Regulation, as published, could lead to capital differentials that will effectively distort competitive market forces that have spread business risk among 8 companies and thus provide a potentially significant and unjustified advantage for AAA-rated mortgage insurers over AA-rated mortgage insurers. Further, the government's unprecedented intervention will create unfair financial advantages that will enable AAA companies to leverage the government-mandated incentives to capture a greater and disproportionate share of the MI business. This advantage would lead to a concentration of counterparty risk for the Enterprises, thereby endangering the safety and soundness of the Enterprises. Congress recognized the inherent danger of lack of risk diversification for the Enterprises in OFHEO's enabling legislation. The purposes of the enabling legislation is to ensure that the Enterprises will have capital sufficient to withstand severe financial stress for a prolonged period of time. Concentrating the Enterprises risk in their low downpayment mortgage portfolio with two mortgage insurance providers, rather than spreading that risk among 8 well capitalized mortgage insurers weakens, rather than strengthens, the Enterprises' ability to withstand severe financial stress, potentially increasing the exposure of the U.S. taxpayers.

Equally important are the consequences to homebuyers. Concentration of pricing power into AAA-rated insurers will increase the cost of homeownership because rather than having 8 well capitalized providers to chose from, consumers will be largely confined to dealing with 2 AAA-rated companies. Additionally, the Regulation will stifle product innovation for high LTV, low- and moderate-income borrowers. The mortgage insurance industry has been a creative and willing partner of the Enterprises in developing products that enable the Enterprises to meet the ambitious affordable housing goals established by HUD. Serious contraction within the mortgage insurance industry, created by the consequences of the Regulation, will leave a vacuum that is unlikely to be filled by competing credit enhancements. Homeownership levels for the most vulnerable segments of our society will suffer.

In addition, mortgage insurance companies, if they are able to upgrade their ratings, may very well be forced to reduce the size and scope of their business and may have to cut back their presence in smaller states and smaller markets that they now serve. These cutbacks would result from the higher capital requirements dictated by the AAA/AA differential in the regulation.

Furthermore none of the federal banking regulators, nor international banking regulators, draw a distinction between AA and AAA-rated counterparties as OFHEO has done. This equivalent treatment of AA and AAA-rated counterparties was seen most recently in the FDIC risk-based capital regulations that were issued late last year.

<u>Conclusion</u>

To summarize PMI's position:

Eliminate the differential in the haircut between AA and AAA-rated mortgage insurance for purposes of the risk-based capital regulations. This change will avoid the unintended consequences of reduced availability of mortgage insurance, a reduction in affordable housing programs, rising costs for homebuyers and increased exposure of the U.S. taxpayers by a change in the business practices of the GSEs and their partners if the Regulation is not changed.

Best regards,

W. ROGER HAUGHTON

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Appendix A:
Comments on December 2001 OFHEO Revision to Nonderivative Counterparty Haircuts

The text of the rationale for the Proposed Rule, beginning at 66 FR 65147 (December 18, 2001), is given in quotes below, with PMI comments following in italics. We note at the inception that according to our evaluation and the experience of the mortgage insurance industry, PMI can safely meet the OFHEO stress test model without any additional capital infusion.

Default Rates

(1) "After re-evaluating the historical data on differences in performance of AA-rated and AAA-rated firms, including data that recently has become available to OFHEO, the Rule's default ratio of three to one (based largely on the average exposure over the past 80 years) appears to be more than is warranted for a period of economic stress."

We agree. It was inappropriate to calibrate relative default rates during stress periods to relative default rates observed over very long periods that primarily consist of nonstressed periods. Relative default rates tend to "compress" during stress periods, so that the ratio of AA to AAA default frequencies drops during a period of stress.

a. "Data were recently made available to OFHEO by Moody's Investors Service for the worst annual cohorts of U.S. investment-grade issuers since 1920, the cohorts formed at the beginning of 1929, 1930, and 1931. The average 10-year default rate for AA-rated issuers (12.25 percent) was 2.6 times as large as the average default rate for AAA-rated issuers (4.72 percent), and the ratio for the worst of the years was only 2.2."

Although this particular data from Moody's provides a more reasonable calibration of the AA default frequency than the earlier OFHEO method, the results still lie above the range of reasonable calibrations of stress default rates for AA bonds. OFHEO's use of data from the Depression period to calibrate stressed default rates suffers from several defects, including:

i. The available data on corporate bond default experience is less reliable for the Depression period than for more recent years, which include periods of substantial stress.

ii. OFHEO chose 1983 and 1984 as the relevant historical period for the credit risk portion of the stress test. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, provides the basis for OFHEO's stress test and requires that characteristics of the stress period not specified explicitly in the law be consistent with the characteristics of the stress period chosen as the relevant historical period. Moody's data show that for the cohorts formed in 1983 and 1984, the ten-year cumulative default rates for AA cohorts were 2.0 percent and 1.8 percent, respectively. This is substantially less than OFHEO's proposed calibration of AA nonderivative counterparty haircuts to a default rate of 8.75 percent. Also, this 1983-84 stress period experience shows that parity of AAA and AA default rates is the most reasonable calibration of the OFHEO counterparty haircuts. For the 1983 and 1984 cohorts, the cumulative ten-year default rates for AAA cohorts actually were slightly higher than the AA experience (2.7 percent and 2.1 percent,

respectively). (Source: Moody's Jan. 1997 publication, "Historical Default Rates of Corporate Bond Issuers, 1920-1996).

iii. *The Depression era bond default data pertains to a period with a significantly different industry mix of bond issuers than the present. Actual default rates from the Depression period were dominated by issuers from the transportation sector, whereas the current economy—and the GSE's counterparty risk profile—is much more oriented towards financial firms and financial instruments. More recent default data, representing current economic circumstances, will show little, if any, difference between AAA- and AA- rated default rates.*

b. "Furthermore, a study of corporate bond quality by W. Braddock Hickman shows 12-year default rates for the cohort formed at the beginning of 1928 for AA-rated issuers (12.3 percent) to be 1.5 times as large as that for AAA-rated issuers (8.1 percent)."

These are equivalent to 10-year default rates of 6.8 percent for AAA and 10.3 percent for AA, using simple linear proration (multiplying by a factor of 10/12) as the method for converting from 12-year to 10-year default rates. The implied AA default rate of about 10 percent from this Hickman data is substantially below OFHEO's chosen default rate of 12-1/2 percent in their nonderivative counterparty credit risk formulas

"More recent data, in relatively favorable economic circumstances, also show greater similarity in the performance of issuers in these two rating categories."

The Moody's 1970-2000 10-year default rates were only 0.7 percent for AAA and 0.8 percent for AA. This more recent data has several advantages over Depression era bond default data as a foundation for stress test calibration, including:

a. *The available data on corporate bond default experience from 1970-2000 is more reliable than for the Depression period.*

b. *This 1970-2000 period includes1983 and 1984, which OFHEO chose as the relevant historical period for the credit risk portion of the stress test and should be used here as well for consistency.*

c. *The modern era bond default data pertains to a period with a more accurate representation of the current industry mix of bond issuers.*

"However, a partially offsetting factor is that Moody's data for both Depression cohorts and averages of all cohorts show that defaults of AAA-rated issuers that occur within 10 years after the cohort is formed occur later in the 10-year period than those of AA-rated issuers."

But, for AA-rated issuers the Moody's data for averages of all cohorts show that defaults occur much later than implied by the original OFHEO 5-year linear phase-in. Also, Moody's data shows average AA-rated default timing that is somewhat later than implied by the revised OFHEO 10-year linear phase-in (until year 8 of the stress period).

(2) "The relationship between AA and AAA defaults is particularly relevant because most Enterprise counterparty and security exposures are either AAA- or AA-rated. An excessive differential between these ratings in the stress test could create inappropriate business incentives for the Enterprises."

We agree. In fact, the December proposed rule still maintains a differential between AAA and AA rated counterparties that is excessive, which could encourage the GSEs to increase counterparty risk by concentrating mortgage insurance at only a few providers.

(3) "After weighing the above considerations, OFHEO proposes to lower the cumulative default rate for AA-rated counterparties and securities to 12.5 percent (from 15 percent), which will be 2.5 times the rate for AAA-rated counterparties and securities."

This is a step in the right direction but does not go far enough in reducing the AA default rate, given the balance of evidence. Modern era data on AAA and AA bond default rates, including that from the 1983 and 1984 stress period cohorts that define the OFHEO benchmark stress period, show that parity of AAA and AA default rates at near zero is the most reasonable calibration. Even if Depression era data is employed, it shows an AA default rate of 10 percent, only slightly higher than the roughly 7 percent default rate of AAA bonds.

Severity Rates

(1) "Historically, corporate bond recoveries have averaged about 40 percent (i.e., a 60 percent loss severity rate) over long periods of time."

We agree that this is roughly the average experience over a long period of time, for a range of issuers and types of bond issues. However the performance of all corporate bonds is an inappropriate proxy for the performance of mortgage insurance companies, which make up the vast majority of the AA-rated counterparties for the GSEs. The recovery rate for senior/ secured bonds, which we believe are a better, but not ideal, proxy for the performance of mortgage insurance companies, more closely approximates the performance of mortgage insurance companies. Mortgage insurance companies by law must give priority to policy holder claims above other debt holders.

a. "A study of default and recovery rates by Moody's shows an average recovery rate of 39 percent over the past 20 years."

   This average includes bonds of all types of seniority/security. Senior secured bonds had higher average defaulted values/recovery rates of 55.3 percent over 1981-1999 and 53.9 percent in 2000 We believe mortgage insurance companies' performance is more like that of senior/secured bonds..

b. "A study of defaulted bond recoveries by Standard and Poor's shows an average recovery rate of 44 percent from 1981 to 1997."

c. "The Hickman study shows an average recovery rate of 43 percent for large issues from 1900 to 1943."

d. "Recoveries on Enterprise holdings of mortgage and other asset-backed securities and on mortgage insurance claims would likely be substantial also, benefiting from asset values in the former case and premium income in the latter."

In addition to the higher recovery rates of senior/secured bonds, application of the OFHEO stress test to a mortgage insurer shows the substantial recovery values from remaining asset values and premium income.

(2) "Data on recoveries in unusually stressful times are less favorable."

We agree with this general statement that recovery rates in stress periods tend to be lower than those in unstressed periods, averaging over a number of different stress periods or focusing on the experience during the Depression. However, as we noted above, OFHEO chose 1983 and 1984 as the relevant historical period for the credit risk portion of the stress test, and for consistency this more recent period of stress also should be used here to calibrate stress recovery rates. Moody's data show average recovery rates well above 40 percent in 1983 and 1984 (see Exhibit 12 of Moody's January 1997 publication "Historical Default Rates of Corporate Bond Issuers, 1920-1996").

a. "Hickman reported an average recovery rate of 34 percent for large issues for defaults in 1930 to 1943."

b. "Moody's has reported average recovery rate estimates that are substantially lower during recessions, and fall as low as 20 percent during the 1930s."

This low near 20 percent for an average recovery rate during the 1930s was for a single year, 1932. The single year results are not representative of stress recovery rates for a ten year stress period.

c. "For 1930 to 1943, Moody's average was 36 percent, despite higher rates during the latter years of that period."

d. "A somewhat lower projection for the stress period used in the rule is, therefore, appropriate."

We disagree that the recovery rate in the OFHEO stress model should be lower than 36 percent. The average recovery rate of about 40 percent over 1981-2000 is more representative of the expected recovery rate during a modern stress period, averaging across all types of issues.

(3) "All of the recovery studies show some differences in recovery rates depending on the presence or absence of secured or subordinated status."

Mortgage insurance claimants have seniority status with respect to remaining asset values and premium income of a defaulted mortgage insurance company, and a well-established insurance regulatory structure secures this entitlement to these asset values and premium income flows. Thus, other things equal, recovery rates on senior/secured defaulted bonds are more relevant to calibrating stress recovery rates on mortgage insurers than are recovery rates on junior/unsecured defaulted bonds. For 1981-1999, Moody's calculated the average recovery rate on senior secured bonds at 55.3 percent, well above OFHEO's proposed 30 percent recovery rate for AA-rated mortgage insurers.

(a) "However, such status is a factor used in determining ratings. Moody's expressly states that securities with different status may have similar probabilities of default, but be rated differently in recognition of the effect of security or subordination on likely recoveries."

Moody's expressly states "Generally speaking, if an obligor suffers credit distress, then all of its obligation-regardless of security/seniority-are at risk of default. Thus, it is generally the case that different security/seniority classes face the same likelihood of default." (Moody's Feb. 2001 publication "Default and Recovery Rates of Corporate Bond Issuers: 2000", pp. 24-25) Also, Moody's states that "Not only does the probability of default rise with lower ratings but also the severity of loss given default rises." (op. cit, p. 26)

(b) "Thus, a secured instrument may have a somewhat higher probability of default than average for its rating, but also have a somewhat higher expectation of recovery."

As noted just above, Moody's indicates that the seniority/security status of debt generally does not significantly change the interpretation of a rating as an indicator of the probability of default. Defaulting issuers tend to default on all obligations, regardless of security/seniority. However, because recovery values of defaulted issues do depend on security/seniority, Moody's uses the practice of "notching" to slightly adjust the ratings of particular issues of investment-grade issuers' debt up or down, depending on their security/seniority status and hence on their expected recovery values in the event of default. (See Moody's Nov. 2000 publication "Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale", p. 3.)

Moody's analysis of 1970-1999 experience shows that an AA issuer with senior unsecured debt rated at the middle of the AA range, Aa2, would have an estimated default rate of 0.98 percent, virtually identical to the estimated 0.77 percent default rate for a AAA issuer with Aaa rated senior unsecured debt. However, if that AA issuer also issued senior secured debt, these latter secured issues would tend to be notched up to the AA1 rating (S&P AA+), reflecting the higher expected recovery value (64 percent versus 49 percent). (Moody's Nov. 2000 op.cit, table 3, p. 7) This notching practice preserves the interpretation of the ratings difference between AA1 and AA2 issues as indicative of small differences in expected loss, to 0.35 percent from 0.50 percent. This same Moody's analysis also shows that a AAA issuer with Aaa rated senior unsecured debt has a rating that implies an expected loss rate of 0.39 percent, virtually identical to the expected loss rate of 0.50 percent for a AA issuer with Aa rated senior unsecured debt.

(c) "Accordingly, OFHEO proposes to specify a recovery rate of 30 percent (70 percent loss severity rate) for all non-derivative counterparties and securities with investment-grade ratings."

We disagree with this proposal to use a uniform recovery rate assumption in the OFHEO stress test, regardless of the rating of the counterparty or the seniority/security of the claim. Moody's emphasis on ratings as indicators of expected credit loss supports using higher than average recovery rates for instruments such as mortgage insurance, which establish seniority of policyholders with respect to asset values and future premium income.

Haircuts

Ratings Classification	Non-derivative Contract Counterparties or Instruments
AAA	3.5%
AA	8.75%
A	14%
BBB	28%
Below BBB and Unrated	100%

The proposed haircut values (loss rates) listed in the OFHEO table given above are calculated by multiplying the proposed default rates by the proposed common loss severity rate of 70 percent. With proposed default rates of 5 percent for AAA and 12.5 percent for AA, the calculated implied haircut loss rates are 3.5 percent for AAA and 8.75 percent for AA. OFHEO's December 2001 proposal of a haircut value of 8.75 percent for AA is an improvement but does not go far enough toward the more reasonable calibration of virtually equal AAA and AA haircut values.

Modern era data on AAA and AA bond default rates, including that from the 1983 and 1984 stress period cohorts that define the OFHEO benchmark stress period, show that parity of AAA and AA default rates at near zero is the most reasonable calibration. Depression era data show slightly higher AA default rates than AAA default rates, but after allowing for the high recovery values this difference is insignificant. The evidence supports parity of AAA and AA final haircut values.

Phase-In

(1) "Under the Rule, haircuts for investment-grade counterparties and securities are phased-in over the first five years of the stress period, so that haircuts are close to zero in the first month of the stress period and rise to their maximums in the 60th month, where they remain for the last five years. In effect, all defaults occur within the first five years, and later haircuts to cash flows simply reflect the consequences of previous defaults, as defaulted counterparties are unable to meet their obligations."

The assumption that all defaults occur within the first five years was quite inappropriate, and the proposed revision to a ten year phase-in period is a substantial improvement. Still, the proposed revision is very conservative and could go further in delaying the timing of assumed defaults by AA counterparties.

For AA bond issuers, Moody's 1970 to 2000 data show that by the end of the fifth year only 37 percent of 10-year cumulative defaults have occurred, on average. This is substantially less than OFHEO's proposed revised assumption that 50 percent of 10-year cumulative defaults have occurred by the end of the fifth stress year.

a. "This conservative approach takes into account that the interest rate shocks and house price shocks all occur in the first half of the stress period."

For AA-rated mortgage insurers as counterparties, the timing of potential default is largely determined by the timing of payments due to the Enterprises on mortgage insurance policies that have experienced claims. Of particular relevance is the time, if any, at which an insurer's sources

of funds is projected to fall short of the needed uses of these funds to pay claims. The OFHEO stress test itself models the timing and amount of claim payments due to the Enterprises.

Although the OFHEO stress test assumes that the large declines in house prices occur in the first half of the stress period, the stress test also implies that about one-quarter of the mortgage insurance claim payments eventually due to the Enterprises arise in the second half of the stress period. The incidence of claim payments is delayed relative to the timing of declines in house prices, as mortgage borrowers have some ability to sustain mortgage payments during the initial phases of the stress test. Also, for those mortgages that do eventually result in mortgage insurance claims, the timing of claim payments is delayed relative to the initial incidence of default by the lengthy amount of time these mortgages would remain in the process of foreclosure.

(2) "Long-term average historical data show more evenly distributed defaults over time, but available data for especially stressful periods (e.g., the 1920s and 1930s) give little indication of timing."

a. "The recently obtained unpublished data from Moody's shows that for the worst cohort (starting in the beginning of 1930), only 57 percent of ten-year investment-grade defaults occurred during the first five years."

b. "While the principal shocks may occur somewhat earlier in the stress period than they did for issuers in the 1930s, a closer approximation of the historical patterns may better reflect the ability of most highly rated firms to survive severe stresses for many years."

c. "Some of those that ultimately fail during the stress period may reasonably be expected to fail during its final years."

d. "Accordingly, OFHEO proposes to extend the phase-in period from five years to ten years for investment-grade counterparties and securities."

This ten year phase-in is superior to a five year phase-in for approximating the delayed defaults shown both in studies of corporate bond defaults and in the application of the OFHEO stress test model itself to a mortgage insurance company.

e. "Thus, for credit exposures to firms and securities rated BBB and higher, defaults will occur evenly throughout the stress period."

This proposed even distribution over stress years for the first occurrence of default by counterparties is quite conservative, particularly as applied to mortgage insurance companies. The evidence supports additional delay in the timing of assumed defaults by AA counterparties.

Appendix B

PMI: Where Affordable Housing is Our Core Business

PMI is committed to expanding homeownership opportunities through responsible and innovative lending structures, outreach and educational initiatives. Specifically, PMI's commitment means increasing home ownership rates in low and moderate income neighborhoods, expanding home ownership levels among low and moderate income consumers and narrowing the disparity between mortgage approval percentages experienced by various ethnic groups in this country.

Habitat for Humanity

Since 1994 PMI has had a close relationship with Habitat for Humanity, a non-profit organization dedicated to eliminating poverty housing. PMI has sponsored 21 Habitat Homes and PMI employees have built 11 Habitat Homes, led by PMI's Chairman and CEO Roger Haughton.

PMI is very proud of its historical involvement with Habitat for Humanity in constructing affordable housing for families in locations throughout the United States. Since 1994, when PMI raised significant contributions for five local Habitat affiliates, PMI has sponsored homes, solicited employees, customers and others to form construction crews for Habitat builds and purchased Habitat-issued bonds that provided financing for mortgages to low-income homeowners

PMI employee crews have constructed Habitat homes in Boston, Massachusetts; Houston, Texas; Pikeville, Kentucky; Redwood City, Concord and Los Angeles, California; Eagle Butte and Rosebud, South Dakota; Americus, Georgia (two homes) and Kansas City, Missouri. PMI has raised hundreds of thousands of dollars for local Habitat affiliates across the country. PMI has given further support to Habitat as one of the first companies to purchase bonds from Habitat's very first offering of "Linda Mae" bonds, securities issued by Habitat and backed by no-interest mortgages on Habitat-built homes. The proceeds from the offering allowed Habitat to work on additional housing.

PROGRAMS

PMI offers several innovative affordable programs. Some of our programs help borrowers purchase a home without depending on gifts, grants or second mortgages to subsidize the downpayment. We also offer numerous underwriting flexibilities including limited consideration of undocumented income, a single back-end ratio and consideration of nontraditional employment and credit histories. PMI works with lenders and housing finance agencies to develop creative risk management structures. A summary of our affordable programs is as follows:

GATEWAY CITIES INITIATIVE

PMI has established a $1 million initiative to provide revolving funds to under served ethnic based largely in ten "Gateway" cities across the United States. In partnership with community groups and our customers, the program funds are being used to newly construct or purchase and rehabilitate existing housing stock, thus creating homeownership opportunities for residents of the selected communities. The initiative is currently operating in Hispanic neighborhoods in Oakland, California; East Los Angeles, California; and Houston, Texas, with other cities planned for the near future.

In Oakland PMI is working with the Unity Council, an community development corporation that serves a largely Hispanic area of the city. PMI established a fund that the Unity Council utilizes to acquire and rehabilitate homes that are then sold to neighborhood residents who have successfully completed a pre-purchase counseling course that the Unity Council developed with PMI's assistance. Once the home is sold and the fund is replenished, the Unity Council can use the money to acquire and rehabilitate another home.

LAYERED CO-INSURANCE

Layered Co-Insurance (LCI) is PMI's risk-sharing product designed to help meet non-standard lending needs. LCI allows for more flexible underwriting guidelines in return for the "co-insurer" agreeing to share, based on a predetermined "layer of risk," in program losses. This structure allows programs to be tailored to the specific needs, limit exposure on high LTV loans, and originate with the confidence that the loans will be insurable. This structure has been used successfully with many housing finance agencies, lenders and non-profits such as the Rhode Island Housing Authority, Chase Home Mortgage and the Cherokee, Chickasaw, Choctaw and Potowatomi Nations.

RURAL LENDING

PMI Mortgage Insurance Co. has extended a $350 million commitment to Chase Manhattan Mortgage Corporation for its Rural Advantage Program, which features low downpayment requirements, custom underwriting guidelines and special eligibility requirements customized to meet the needs of rural homebuyers. Chase has named PMI as the exclusive provider of mortgage insurance for the program nationwide.

CONSUMER CREDIT COUNSELING SERVICES (CCCS)

Through our alliance with Consumer Credit Counselors of San Francisco (CCCS) and National Foundation for Consumer Credit affiliated agencies, PMI provides both English and Spanish pre-purchase education. PMI also provides to first-time homebuyers and borrowers with 5% or less downpayment, early delinquency intervention and post-purchase counseling nationwide. In CCCS, PMI has selected an experienced, nationally known organization that specializes in helping individuals gain control of their finances.

NEIGHBORHOOD HOUSING SERVICES OF AMERICA (NHSA)

NHSA is a nationwide alternative finance system using community-based lenders as their origination system. PMI and NHSA are working with over 60 for-profit and non-profit lenders to finance homeownership in some of America's neediest communities and creating lending opportunities in scores of under served urban neighborhoods.

CO-DEVELOPED PRODUCTS

PMI is committed to seek out opportunities and develop products for emerging niche markets. These experimental programs can help PMI, lenders and the Enterprises gain more experience with sub-segments of the affordable housing market. Our Emerging Markets team works with lenders and the Enterprises to design and launch new innovations to their affordable product line to better serve the needs of low and moderate income borrowers.

NATIVE AMERICAN INITIATIVES

PMI continues to work with lenders, housing agencies, non-profit groups and tribal governments to make funds available to Native American tribes, for the purchase or construction of owner occupied properties. PMI works closely with lenders and the Enterprises to develop programs that provide very low downpayment options to tribal members purchasing properties on and off trust lands.

Our current Native American partnerships include the following:

- Chickasaw, Choctaw and Citizen Potawatomi Nations of Oklahoma
- Ute tribe of Utah
- Menominee tribe of Wisconsin
- Navajo Partnership for Housing
- Pueblo of Acoma Housing Authority
- Saginaw Chippewa Housing

Navajo

On the Navajo reservation PMI is working closely with the Navajo Partnership for Housing to create a residential real estate market by establishing a fund for the acquisition and rehabilitation of homes, that are then sold to tribal members with mortgage financing. Because so few residential financing alternatives exist on Native American reservations, tribal members have few options if they would like to sell their home and relocate to another area. The PMI/Navajo Partnership for Housing effort, is designed to create additional alternatives that will lead to a private real estate market that is enjoyed by everyone else in the U.S.

Acoma

The Acoma Pueblo, located in New Mexico and continuously inhabited since 600 A.D., has never had a home financed with a mortgage. Private ownership of homes is nearly non-existent. PMI is working with Acoma to build a modern subdivision of homes, that will be individually owned and financed with mortgages. The objective is to create a private residential real estate market where none exists presently.

Wells Fargo

PMI has formed a strategic alliance with Wells Fargo Mortgage and pledged at least $1 million to expand borrower outreach and conduct homebuyer education on Native American reservations throughout the U.S. Very little privately owned housing exists on
Native American reservations, the shelter that is available is government-owned and
tribal members have little or no experience with private ownership. The PMI-Wells Fargo initiative is designed to educate tribal members on the opportunities and responsibilities that private homeownership offers them.

Strategic Alliances

PMI has formed a number of strategic alliances with non-profit organizations to expand housing opportunities for low and moderate income families either through lending programs and/or home buyer education programs.

- AFL-CIO Housing Investment Trust
- California Public Employees Retirement System
- Consumer Credit Counseling Service
- Los Angeles Consumer Credit Counseling – Goal of reducing predatory lending in the predominantly low income community of East Los Angeles
- Neighborhood Reinvestment Corp.
- Neighborhood Housing Services of America
- American Home Ownership and Counseling Institute
- National American Indian Housing Council
- Idaho Housing and Development Authority
- West Virginia Housing
- North Dakota Housing
- South Dakota Housing

Under PMI's strategic alliance with the Neighborhood Reinvestment Corporation PMI has made a 5-year, $100,000 commitment to fund affordable housing efforts. With the National American Indian Housing Council, PMI funded a homebuyer education course that is being used by numerous Native American housing authorities as they prepare tribal members for the responsibilities for homeownership.

Awards

PMI has been recognized for its affordable housing work with a number of awards including:

- Corporate Social Responsibility Award from the Mexican American Legal Defense and Education Fund
- Platinum Award from the Navajo Partnership for Housing
- Social Compact Award
- Certificate of Congressional Recognition for faith-based affordable housing initiative.