April 14, 2000

Mr. Alfred Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, DC 20552

RE: *GE Supplemental Response to Notice of Proposed Rulemaking On Risk-Based Capital Regulation*

Dear Mr. Pollard:

This letter supplements the comment ("Comment") submitted on March 10, 2000 by GE Capital Mortgage Corporation and its affiliates ("GE") regarding the Second Notice of Proposed Rulemaking on Risk-Based Capital Regulation ("NPR2") and the risk-based capital model (the "Model") proposed by the Office of Federal Housing Enterprise Oversight ("OFHEO") to implement the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "Act").

We are delighted to admit to one partly faulty prediction. In our Comment, we suggested that "the Model's complexity has diminished both the number of comments that could be thoughtfully and completely developed, and the number of parties that would/could contribute or respond." The 59 comments received by OFHEO represent a substantial cross-section of opinion. However, it is also worth noting that we stated that "[w]ithout replicating the Model, other entities are limited to housing policy arguments." OFHEO needs to consider all comments submitted, but respectfully we would ask that, as OFHEO sorts through the numerous comments, it distinguish between those comments based on the painstaking replication of the Model and the technical analysis provided and those which simply express an opinion. All commentators have a particular interest in NPR2. OFHEO, as a financial safety and soundness regulator, should not be swayed by housing policy considerations or the number of similar comments on a particular point.

Having said that, this letter responds in large part to the concerns expressed most frequently in the body of comments submitted. This letter will have a four-part response regarding the need for: (1) a workable process for implementation and use of the Model; (2) maintenance of a simple and empirically justified approach to counterparty "haircuts"; (3) balance between acknowledging the importance of our national goal to enhance the supply of affordable housing and setting prudent capital standards for Fannie Mae and Freddie Mac (collectively, the "GSEs"); and (4) other simple adjustments that will help ensure that the Model is prudent and dynamic. We believe that NPR2 should enable the GSEs to have sufficient capital to withstand the mandated ten year stress period and that, due to the enormous size and importance of the GSEs and the potential catastrophic

consequences of underestimating capital, it would be more responsible to err on the side of holding more capital than less.

Our conclusions and recommendations have not materially changed. OFHEO can implement its Model without exhaustive additional rulemaking, and is right to take a cautious approach toward the issue of counterparty security. However, the Model does have a few shortcomings that need to be addressed. It discourages low down payment lending and generates capital standards that are too low when the credit and interest rate stresses are combined. In addition, the Model may interfere with the GSEs' ability to provide stability and liquidity in the residential mortgage finance marketplace in all market cycles.

We offer the following additional comments to address issues raised by various commentators on the proposed rule.

1. **OFHEO was correct to reject a regulatory approach based on the use of internal models. However, OFHEO should meet the GSEs' concerns regarding: (i) improving the proposed Model so that it accommodates innovation and links capital to risk, and (ii) making the implementation of the regulation operationally workable. We believe the latter can be accomplished by (a) engaging in a brief, concentrated round of negotiated rulemaking with the GSEs and other interested parties regarding the Model, (b) giving the final version of the Model to the GSEs to apply, subject to OFHEO audit and oversight, and (c) making extensive and consistent use of an external technical advisory board for new product/service reviews and ongoing Model adjustments and enhancements.**

In addition to the GSEs, which have made their preferences for the use of internal models in earlier parts of this rulemaking, certain commentators restated the case for internal models as opposed to externally developed and imposed ones such as the Model. Although arguments can be made for internal risk models, we strongly support OFHEO's use of the Model and concur with OFHEO's determination that an externally developed risk-based capital test is consistent with the Act. The GSEs' managerial and operational tasks are not impossible: the General Electric Company, General Electric Mortgage Insurance Corporation and numerous other rated GE entities with managerial and operational concerns as or more complex than the GSEs manage their businesses effectively while remaining subject to external stress test models used to determine their credit ratings.

However, the commentators have made an important point. The Model has to allow the GSEs to practically manage their business and anticipate capital requirements, which we think has two components.

First, GE, the GSEs, and other commentators have suggested many changes to the Model. These suggestions need to be analyzed and considered. Although there are many thoughtful comments, many suggestions contradict each other. It will be very difficult to address all concerns timely and determine which ones merit acceptance. Rather than OFHEO act on its own, we suggest a

concerted effort at negotiated rulemaking to consider proposed changes and make necessary adjustments. Our Comment (at page 22) urged OFHEO to consider appointment of a technical advisory board to benefit from the expertise developed by commentators in their review of NPR2 and to bolster public confidence in the regulatory determinations derived from the Model. Based on the GSEs' concerns, we would suggest importing this concept into the rulemaking process itself. All parties would benefit from an open dialogue regarding the issues presented and the expertise available to imbed any needed adjustments in the Model. Other regulatory agencies regularly use the negotiated rulemaking format, and its application would be ideal to hasten implementation of the Model in a responsible fashion. Indeed, we believe such an effort could complete the task in 3-4 months, which would allow implementation this year. Of course, OFHEO would serve as final authority in the consideration of issues and development of solutions.

Second, once an acceptable Model has been created, we suggest giving the Model to the GSEs to use. The GSEs could build automated linkages between their proprietary systems and databases to the input section of the Model. OFHEO could audit the inputs to ensure data integrity and completeness. The GSEs are more capable than any other entity (OFHEO included) of integrating the Model into their business operations, and delegating this responsibility would address the concerns of the GSEs regarding an externally imposed and administered stress test. However, the Model needs to be the one developed through the NPR2 rulemaking process. To that end, OFHEO needs to exercise its examination, audit and oversight authority on a regular and systematic basis to validate that no unauthorized changes have been made to its Model. We also recommend that OFHEO make use of the technical advisory board as a source of independent expertise and guidance during the implementation period. We believe that this process could be used effectively within the context on new product review and approval as well to mediate any differences between OFHEO and the GSEs.

2. OFHEO was correct to establish meaningful counterparty discounts.

OFHEO's proposed counterparty discounts (or "haircuts") in NPRR2 attracted the largest number of negative comments. The comments clustered around three points: (a) the distinction between "AAA" and "AA" rated entities and instruments, (b) the treatment of entities rated below "BBB" and unrated entities and instruments, and (c) the overall severity of the proposed haircuts.

However, before we respond specifically to the concerns, a more general point needs to be made. Rating Agencies generally limit the amount of counterparty support (or "soft" capital) that a highly rated entity may enjoy by requiring a prudent amount of "hard" or retained capital[1]. Neither OFHEO nor any commentator (including GE) has suggested such a limitation, even though the Rating Agencies have given the GSEs "AAA" ratings based partially on their implied

[1] "For highly-leveraged financial guarantee insurance companies, capital is a critically important component of financial strength. To achieve strong credit ratings, a financial guarantor must, among other things, maintain sufficient amounts of readily accessible paid-in "hard" capital to absorb potential insurance claims and other operating losses as they occur." Moody's Investors Service, "Moody's Assesses Financial Guaranty Soft Capital," (Sept. 1999). Other Rating Agencies such as Fitch and Standard & Poor's have very similar standards for financial guarantors. The GSEs' guarantee activities are a form of financial guarantee insurance.

guarantee[2]. Since no person has suggested any aggregate limit on counterparty participation (whether for interest rate or credit risk mitigation), the GSEs have unlimited discretion to transfer risk to third parties.

As a provider of credit risk mitigation, we welcome the opportunity to provide such services to the GSEs, but the reasonableness of any haircut scheme becomes especially important when there are no aggregate limits on counterparty support. The haircut scheme should reflect empirical data and acceptable industry practice, and encourage the GSEs to use counterparties that will expose them to minimal risk of default or downward "ratings migration". Incenting the GSEs to use the strongest counterparties will reduce the GSEs' risk of default and capital volatility. In addition, the haircut proposal should be uniformly applied based on external public ratings. It should not establish different haircut percentages based on counterparty identity (*e.g.*, lender, insurance company, etc.) or transaction type (*e.g.*, insurance contract, derivative instrument, etc.).[3] Treasury securities or cash, in which the GSEs have a perfected security interest, should be considered the safest counterparty commitment and receive the lowest haircut. Any other form of credit or interest rate mitigation, **including all derivatives**, should be based on the public rating of the counterparty. And, in the United States, where the Rating Agencies are very well established, there is no reason why any GSE internal ratings system is necessary. Neither the cost nor the availability of a rating is prohibitive for a commercial concern.[4]

Equally important, the haircut scheme proposed by OFHEO does not need to raise the costs of homeownership (as we noted in our Comment at page 75). Lower rated counterparties whose credit or interest rate support receives larger haircuts should be able to offset the decreased value of their support to the GSEs through better pricing for their services and products. Several commentators missed this possibility. For example, all mortgage insurers generally charge similar premium amounts for primary mortgage insurance even though the Rating Agencies require "AAA" rated MIs to carry more capital than "AA" rated MIs. If OFHEO adheres to its distinction between "AAA" and "AA" rated entities (and we strongly believe it should), the easiest way to maintain competition among the MIs (a concern for some commentators) is for the "AA" rated companies to reduce their premium charges, since "AA" rated companies can charge less premium and obtain the same return because of their lower

[2] "Our rating foci are government support, legislative changes that could affect the company, asset/liability management and asset quality." Moody's Investors Service, "Federal Home Loan Mortgage Corp." (Feb. 29, 2000); "Federal National Mortgage Association" (Feb. 29, 2000).

[3] For example, a number of commentators expressed concern regarding the proposed treatment of unrated participants in the GSEs' DUS multifamily program. We have not examined the program in detail, but would note that mortgage insurers, whose principal business is assessing mortgage credit risk, have been unsuccessful in underwriting commercial mortgage insurance (of which multifamily risk is the largest component) due to the less predictable nature of the risk. Given the volatility of the risk, we think the GSEs' multifamily programs should not be exempted from the uniform counterparty haircut approach proposed by GE.

[4] We note the expressions of concern regarding unrated counterparty haircuts from certain commentators representing non-profit affordable housing organizations. Regarding their concerns, the GSEs simply could, as Congress has recognized, accept a lower return on "recourse" programs done with affordable housing organizations. Alternatively, the affordable organizations could collateralize their recourse obligations (which we believe is not uncommon for such arrangements), seek a rating, or work with higher rated lenders and/or mortgage insurers to provide additional credit enhancement for the loans.

capital requirement.[5] Then, if the GSEs decide to pay more for loans with "AAA" rated mortgage insurance, this price differential would be offset by the lower MI premium. Thus, the consumer's monthly payment would be unchanged. In short, we are surprised why simple market economics won't address the "advantage" of higher rated companies.

The last point we want to make concerning "AAA" ratings is to address the concern expressed by some commentators that concentrating credit enhancement activity with only "those few institutions with AAA ratings" because of the favorable capital effect "may be to increase rather than reduce risk." Those commentators should consider the following from a risk perspective:

(i) Increasing one's "concentration exposure" to "AAA" entities or instruments will not increase risk. The empirical data clearly demonstrate that a "AAA" rated entity or instrument has significantly lower default rates versus all other ratings. We believe that OFHEO should encourage "concentration exposure" to the least risky and most prudent counterparties.

(ii) If the GSEs are concerned about concentration risk, they should propose internal limits on all counterparties, with lesser rated counterparties receiving proportionally smaller limits and "AAA" counterparties receiving the largest limit.

(iii) If credit-enhancement concentration risk is a concern, the concern applies equally to interest-rate counterparty concentration risk. Although larger in number, the universe of "AAA" interest rate counterparties still is limited, and also could raise concentration concerns.

(iv) If the GSEs truly are concerned about concentration limits, they should (a) embrace the concept proposed by the US Treasury that banks should be limited to how much GSE debt they can hold, since "AAA" rated GSE debt might pose similar concentration risks, and (b) consider their position as guarantors of more than 73% of all conforming mortgage credit risk as of 1998.

We believe "AAA concentration concerns" are overstated and not grounded in significant risk management concerns.

"AAA"/"AA" Default Probability and Ratings Migration Data

Briefly, we would like to review the data comparing the differences in default probabilities between rated instruments. Our Comment stated, but did not present data, that "AAA" and "AA" rated instruments and entities have different default probabilities, as Tables 1 and 2 demonstrate. Another commentator thoughtfully raised the issue of "ratings migration," or the probability that an entity or instrument will move up or (more importantly in this case) down in ratings category, creating capital volatility. The differences between each rating category are clearly demonstrated, as follows:

[5] The commentator who serves as a director of PMI should know this, since PMI was founded as a "AA" rated company, became "AAA" rated as part of the Allstate Group, and became "AA" again after it separated from Allstate. The presence or absence of parental support, while important, is not the sole determinant of a "AAA" rating, either: GEMICO has been a "AA" and a "AAA" rated company when owned by GE, and RMIC, which is owned by the Old Republic Group, is a "AA" currently.

Table 1

Average Corporate Issue Default Rates By Rating
By Number of Years Following Given Rating – 1920-1999

	Default Rates By Rating By Years Following Rating					*Ratio of Default Rates By Rating to "AAA" Default Rates*			
Rating	**5 Yrs.**	**10 Yrs.**	**15 Yrs.**	**20 Yrs.**		**5 Yrs.**	**10 Yrs.**	**15 Yrs.**	**20 Yrs.**
AAA	0.20%	1.09%	1.89%	2.38%		1.00	1.00	1.00	1.00
AA	0.97%	3.10%	5.61%	6.75%		4.85	2.84	2.97	2.84
A	1.37%	3.61%	6.13%	7.47%		6.85	3.31	3.24	3.14
BBB	3.51%	7.92%	11.46%	13.95%		17.55	7.27	6.06	5.86
BB	10.04%	19.05%	25.95%	30.82%		50.20	17.48	13.73	12.95
B	20.89%	31.90%	39.17%	43.70%		104.45	29.27	20.72	18.36

Source: "Historical Default Rates of Corporate Bond Issuers, 1920-1999", Moody's Investors Service, January 2000

First, as Table 1 demonstrates regarding general corporate bond issues, "AAA" corporate issuers have a significantly different and consistently better default record relative to "AA" issuers across all time periods. **Specifically, "AA" rated issuers had long-term average default rates that are 3 to 5 times larger than that of "AAA" rated issuers**. The data also clearly shows that below investment grade issuers have significantly higher default rates than "BBB" and above issuers.

Table 2

Corporate Bond Average Rating Transition Matrix, 1980-1999

	Rating to:	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**Probability AA or Higher**
Rating From:	**AAA**	**85.88%**	9.76%	0.48%	0.00%	0.03%	0.00%	0.00%	95.64%
	AA	0.92%	**84.87%**	9.64%	0.36%	0.15%	0.02%	0.00%	85.79%
	A	0.08%	2.24%	**86.24%**	6.09%	0.77%	0.21%	0.00%	2.32%
	BBB	0.08%	0.37%	6.02%	**79.16%**	6.48%	1.30%	0.11%	0.45%
	BB	0.03%	0.08%	0.46%	4.02%	**76.76%**	7.88%	0.47%	0.11%
	B	0.01%	0.04%	0.16%	0.53%	5.86%	**76.07%**	2.74%	0.05%
	CCC	0.00%	0.00%	0.00%	1.00%	2.79%	5.38%	**56.74%**	0.00%
	Source: "Historical Default Rates of Corporate Bond Issuers, 1920-1999", Moody's Investors Service, January 2000								

Second, as Table 2 demonstrates, "ratings migration data" also reveal significant differences among rated corporate issuers even in normal economic times. Of particular concern is ratings

migration risk. Ratings migration risk is the likelihood of a ratings downgrade after the initial rating is established. In terms of stability of rating categories:

- For upgrades in ratings, "A" rated companies are 2.43 times more likely to be upgraded to "AA" than "AA" being upgraded to "AAA" (2.24% ÷ .92%). In fact, the likelihood of a "AA" rated company being upgraded one rating class (to "AAA") is the least likely probability of any rating class receiving a one rating class improvement. This reflects the exceptional financial strength of "AAA" and the difficulty in achieving this most desired rating.

- **For downgrades, "AA" rated companies are 20 times more likely to fall to "A" than a "AAA" rated company** (9.64% ÷ .48%). The possibility of a "AAA" falling two rating categories is clearly a remote possibility.

Third, Freddie Mac (at page 136 of their comments on NPR2) offered the curious comment that "[r]ating agency assessment of mortgage insurer counterparty risk must be interpreted in the limited context of structured finance.[6]" We do not accept this statement (even though excellent performance data would strengthen our argument for favorable "AAA" treatment). Table 3 below demonstrates ratings migration data for rated instruments in the form of structured finance residential mortgage-backed securities ("RMBS") since 1978. This data shows that the differences between "AAA" and "AA" ratings are even more significant than for corporate bond issuers.

- **"AAA" rated RMBS have a zero ever-to-date default compared to the 1.47% default rate of "AA" rated RMBS**.

- **"AA" rated RMBS were 100 times more likely to fall below "AA" than "AAA" rated RMBS.**

Table 3

[6] We use the term curious, since Standard & Poor's in its description of the rating methodology used for Freddie Mac states that "S&P draws from the following areas in its analysis: analysis of private mortgage insurers for the off-balance sheet business; analysis of portfolio lenders for the on-balance sheet business; **and, because mortgage insurers provide support for mortgages with LTVs greater than 80%, analysis of credit issues relating to mortgages with LTVs less than 80% draws from structured finance.**" Final Report of S&P to OFHEO (Feb. 3, 1997) at 4. Thus, it is unclear why Freddie Mac has offered this comment regarding MI and structured finance. We firmly believe that mortgage insurance offers much more than structured finance vehicles which, per Freddie Mac, "have little ongoing risk management capability, no diversification across pools and no ability to retain earnings."

US Residential MBS Rating Changes by Initial Rating 1978-1999										
	Rating To: (Across)	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**Ever-To-Date Default**	**Probability AA or Higher**
	AAA	**99.13**%	0.76%	0.00%	0.03%	0.03%	0.00%	0.03%	0.00%	99.90%
Rating From: (Down)	**AA**	16.90%	**72.68**%	6.68%	1.07%	0.13%	0.07%	1.00%	1.47%	89.58%
	A	2.07%	4.31%	**87.76**%	4.66%	0.17%	0.00%	0.00%	1.03%	6.38%
	BBB	0.42%	1.68%	4.19%	**89.94**%	1.47%	0.21%	0.63%	1.47%	2.10%
	BB	0.00%	0.00%	0.00%	0.84%	**92.89**%	2.93%	0.84%	2.51%	0.00%
	B	0.00%	0.00%	0.00%	0.41%	2.07%	**88.84**%	2.48%	6.20%	0.00%
	CCC	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	**100.00**%	0.00%	0.00%
	Source: "Performance of US RMBS Credit Ratings, 1978-1999", Standard & Poor's Rating Services									

In addition, Table 4 demonstrates that **"AAA" rated structured finance instruments carry 1.6 to 2.5 times more credit enhancement than that required for "AA" rated instruments, which helps to mitigate against default or downgrade**.

Table 4

Standard & Poor's Credit Enhancement Levels For Residential Mortgage-Backed Securities (RMBS)				
		AAA	**AA**	**Ratio: "AAA"/"AA"**
LTV				
60		3.00%	1.20%	2.50
65		4.13%	2.00%	2.06
70		5.25%	2.80%	1.88
80		6.45%	4.00%	1.61
90		6.98%	4.35%	1.60
95		13.50%	8.10%	1.67
Source: "Residential Mortgage Criteria", Standard & Poor's Structured ***Finance Ratings Group, November, 1999***				

Thus, "AA" rated companies are both more likely to default and get downgraded to "A" than "AAA" rated companies, which will result in increased risks and capital variability for the GSEs. OFHEO recognized this difference in NPR2, and we would urge OFHEO to maintain this distinction since it is based on credible historical data.

Lesser-Rated and Unrated Counterparty Default Probability and Ratings Migration

A number of commentators also addressed the treatment of lesser-rated or unrated counterparties. We explained our rationale in our Comment (at page 75) for recognizing the greater default potential of such counterparties. Tables 1, 2 and 3 above provide additional support for our rationale. Briefly:

- **In terms of long run average corporate bond issuer 10 year cumulative defaults in Table 1, "BBB," or the lowest investment grade rating, was 7.3 times more likely to default than "AAA" issues, and lesser rated issues were significantly worse (for "BB," 17.5 times, and 29.3 times for "B").**

- **In terms of "ratings migration" data for corporate bond issuers in Table 2, the probability of a "BB" falling to "CCC" was 4 times higher than a "BBB". The probability of a "B" falling to "CCC" was 25 times higher than a "BBB".**

Thus, based on published data, it is difficult to see why OFHEO, as safety and soundness regulator, would want to encourage reliance on "BBB" or lesser rated counterparties. And, as noted above, we believe that the general availability of ratings eliminates the need for a special category for unrated entities or instruments.

GSE Haircut Critiques and Alternative Proposals

Many commentators criticized the haircuts proposed by OFHEO in NPR2 as too severe. However, few commentators provided detailed analytical support for their criticism of OFHEO's approach, so we have concentrated on the GSEs' critique of OFHEO's approach and their proposed alternatives.

As an initial matter, the GSEs concluded that the discounts were too severe in light of historical corporate bond performance, and suggested the following maximum discounts shown in Table 5:

Table 5

GSE Proposed Maximum Counterparty Discount Schedules			
Rating Category	**Fannie Mae Proposal**	**Freddie Mac Proposal**	**OFHEO Proposal**
AAA	1.5%	1.2%	10%
AA	2.0%	1.5%	20%
A	4.0%	2.3%	40%
BBB	6.0%	6.6%	80%
<BBB	6.0%	6.6%	80%

Both GSEs cite Moody's Investors Service's "Historical Default Rates of Corporate Bond Issuers, 1920-1999", as well as a 1958 study by W.B. Hickman, "Corporate Bond Quality and Investor Experience," (analyzing corporate bond default rates from 1900-1944),[7] as evidence that actual corporate default rates were never as severe as assumed by OFHEO in its stress test assumptions.

[7] Both GSEs refer to Table 36 on page 190 of the Hickman study.

However, the Hickman study, as referenced by the GSEs, has three significant limitations as a source of guidance for OFHEO regarding counterparty haircuts. First, the default data cited by the GSEs from Hickman refers to the performance of large issues only and not the entire universe of issues. Left uncited were numerous other exhibits in Hickman that demonstrated that smaller issues suffered substantially higher default rates within the same rating categories. Thus, the GSEs' respective haircut proposals are understated and flawed.

In addition, the Hickman study used quadrennial default data, which the GSEs have converted into 10-year default rates. The conversion exercise is not impossible, but it cannot have been accomplished without having access to ratings migration information to account for downgrades over each of the four-year periods. Without such information it would be impossible to isolate succeeding period defaults to original starting year ratings. The information published in the Hickman study lacks such transition detail, so the GSEs' estimated 10-year default estimates are unreliable.

Second, the Hickman study clearly does not support the GSEs' position on the proposed discounts on below investment grade and unrated corporate issuers, which is to give those entities a discount similar to "BBB" rated entities. As Table 6 demonstrates, **speculative grade ("BB", "B" and "CCC") performance generally was more than 6.5 times worse than investment grade, with the performance of those issues with no rating not far behind**.

Table 6

Quadrennial Default Rates For High and Low Agency Ratings
at Beginning of Periods

		Investment Grade	<BBB	No Rating	Ratio <BBB/Inv	Ratio No Rat/Inv
All Issues						
	1928-1931	1.4%	22.6%	7.2%	16.14	5.14
	1932-1935	6.2%	48.9%	49.2%	7.89	7.94
	1936-1939	3.3%	21.7%	8.0%	6.58	2.42
Large Issues						
	1928-1931	0.8%	21.5%	6.3%	26.88	7.88
	1932-1935	6.1%	46.6%	54.3%	7.64	8.90
	1936-1939	3.3%	24.2%	0.0%	7.33	0.00
Small Issues						
	1928-1931	4.6%	24.1%	7.5%	5.24	1.63
	1932-1935	7.1%	58.5%	48.2%	8.24	6.79
	1936-1939	3.3%	10.3%	12.2%	3.12	3.70

W.B. Hickman, "Corporate Bond Quality and Investor Experience,"
National Bureau of Economic Research, Princeton University Press (1958), p.189

Further, the Hickman study clearly shows firms of smaller asset size experienced substantially higher default rates. We expressed concerns in our Comment (at page 76) regarding the application of a "BBB" rating equivalency for GSE seller/servicer recourse obligations. The

Hickman study potentially provides additional support for viewing unrated seller/servicers (with few liquid assets beyond their servicing rights) as substantially weaker in terms of counterparty security. GE renews its recommendation that OFHEO adopt our proposal that unrated and below investment grade counterparties should be given no capital credit for purposes of the RBC test.

The other major source of information regarding past performance of rated issuers is the Moody's historical corporate default series[8], which measures long-run average default rates by rating category by number of years since such rating identification, as well as the standard deviations about each average by time elapsed. The long run averages provide a true long run mean. The standard deviations permit the statistically valid estimation of possible worst case outcomes. Consequently, the Moody's series surpasses the Hickman study in terms of being able to assess cumulative default worst case scenarios by proper rating category for specific lapsed time intervals.

However, the GSEs have used the Moody's time series selectively as support for their proposed haircut tables. Freddie Mac used only part of the Moody's time series in its comment, choosing to use 10-year average default rates for 1970-1999 instead of the 1920-1999 data, ignoring 50 years of historical performance data. We find Freddie Mac's rationale unsupportable. Freddie Mac claims that it is inappropriate to assume corporate default rates that approach the worst levels of the Depression, since corporate default rates during the West South Central mid-1980s recession did not demonstrate the same level of corporate defaults. However, Freddie Mac has misinterpreted the intent of the Model, which is to mimic a severe national economic stress, commonly referred to as a depression. Corporate default rates in the mid-1980s were not as severe as they were in the Depression, but only because the conditions that occurred in the West South Central region did not occur nationwide. Thus, use of the Moody's data series from 1920-1999, which includes the Depression era, is in fact more appropriate.

Freddie Mac used recent average default rates (1970-1999), multiplied those rates times three, and then assumed a 50% recovery rate times that product to develop its proposed maximum haircut.[9] In our view, the proper way to estimate a statistically valid worst case observation is to use the average observation plus three standard deviations rather than a multiple of the average. In Table 7 below, we have used the Moody's 1920-1999 average cumulative 10-year default rates and 10-year standard deviations. In terms of just investment grade levels, the worst-case default rates as estimated are 4.6 times the long-run average default rates, which is a multiple more in line with the BLE scenario at 4.5 times long-run average conforming loan loss rates. To the extent that OFHEO wishes to adopt a simple formulaic method for determining counterparty haircuts,

[8] The latest report published in January 2000 covers default rates from 1920-1999.

[9] Freddie Mac's use of a multiple of three times the average default rate by rating is based on its claim that the BLE default rates are three times its own long-term average loan performance. This claim directly conflicts with references Freddie Mac makes on page 16 of its comments to OFHEO: "In NPR1, OFHEO estimated a benchmark loss rate of **9.4** percent. OFHEO acknowledged that this rate far exceeds **the typical loss rate**, noting that the aggregate loss rate on the 48 states and the District of Columbia for all origination years from 1979 through 1985 was **2.1** percent." By GE's calculation, 9.4 is 4.5 times higher than 2.1. If Freddie Mac's stated multiple of 3 is accurate, Freddie Mac's long-run average loan performance would have to be 50% worse (4.5/3=1.49) than the US conforming loan performance between 1979 and 1985.

we submit that the approach presented in Table 7 is the more statistically valid way of estimating appropriate high stress level 10-year default rates on rated counterparties.

Table 7

Worst Case Statistically Derived Corporate Default Rates By Rating Category
Using Moody's 1920-1999 Long-Run Average 10 Year
Default Rates and Standard Deviations

				Statistical Worst Case	
	Moody's 10 Year Average Cumulative Default Rates 1920-1999	10 Year Cumulative Standard Deviation	3 Times STDEV	Average Plus 3 STDEV	Proposal/ 10 LR Avg
AAA	1.1%	1.5%	4.5%	**5.6%**	5.16
AA	3.1%	3.4%	10.2%	**13.3%**	4.30
A	3.6%	5.5%	16.4%	**20.1%**	5.55
BBB	7.9%	9.1%	27.2%	**35.1%**	4.43
BB	19.1%	13.8%	41.3%	**60.3%**	3.17
B & Unrated	31.9%	19.7%	59.1%	**91.0%**	2.85
Investment Grade	4.9%	5.8%	17.4%	22.3%	**4.59**
Speculative Grade	25.3%	15.2%	45.6%	70.9%	2.80
	1979-1985 US Average Conforming Loan 10-Year Loss Rates			**BLE Loss Rates**	**BLE/ US Avg Loss Rates**
Mortgage Loss Rate	**2.1%**			**9.4%**	**4.48**

Sources: "Historical Default Rates of Corporate Bond Issuers, 1920-1999", Moody's Investors Service, January 2000

Fannie Mae uses the Hickman data differently. Fannie Mae adjusts corporate default data to remove the effect of the poor default performance of railroad bonds, which suffered substantially higher default rates than any other industry.[10] Thus, Fannie Mae suggests that non-railroad corporate defaults are a more appropriate indicator. Fannie Mae then moves to the more recent Moody's corporate bond default data (1970-1999) to recommend a discount of 3% for "AAA"

[10] Interestingly, the Moody's data have very little information regarding the performance of banks (particularly mortgage, or "land" banks) during the Depression, whose failures were numerous enough to impel creation of both a new system of financial regulation and new entities, including Fannie Mae. Given the systemic financial collapse that occurred, Fannie Mae's analysis might be backward: it might be more accurate to use railroad default performance as a proxy rather than excluding it entirely.

(apparently because corporate issuers rated "AAA" in 1983 had a ten-year default rate of 3.02%). It appears that the rest of Fannie Mae's proposed haircuts is not derived from the Moody's data.

Thus, the GSEs' proposed haircut treatment for counterparties uses their primary data sources incompletely and misleadingly in comparison to standard statistically valid approaches. The GSEs' proposed haircut treatments are neither more reasonable nor better supported than the approach suggested by OFHEO in NPR2 (although we believe OFHEO needs to revise its "BBB" haircut proposal for unrated and below investment grade entities).

The GSEs' concept of recovery rates deserves some discussion as well, since the concept has initial appeal until subjected to more detailed analysis. Both GSEs cite Moody's as support for the proposition that any estimate of discount rates should be further reduced by the assumption of some recovery rate. For example, Fannie Mae cites recovery values of 50% or more for underlying security asset values experienced during the Depression, and strongly suggests that such a recovery assumption be applied to credit enhancements where the borrowers' payments for such coverage could be assumed by the GSEs. Regarding seller/servicer recourse, Fannie Mae argues that an entity's mortgage servicing rights serves as another form of offset, and proposes that the value of such servicing rights also be assumed to provide a 50% recovery value. Freddie Mac offers a similar recovery value argument based on its claimed 50% recovery rate on MI premiums following problems with TICOR/TIMIC, a mortgage insurer that failed in the 1980s, and both GSEs apply a similar rationale to spread accounts.

The simple recovery rate concept has several problems, however. The first problem lies in the contingent nature of the concept. Moody's uses the trading price of defaulted instruments as a proxy for the present value of the ultimate recovery on a defaulted bond, but Moody's notes that such valuation varies with seniority of the lien as well as with the stated security of the debt. In addition, variations in recovery rates for defaulted bonds are correlated with macroeconomic conditions and the aggregate risk of default, so recovery rates would proportionately decline as economic conditions became harsher. For example, in 1999, which few would characterize as a troubled economy, prices on all types of defaulted bonds fell below 40%. In 1981, at the start of the worst economic recession since the Depression, prices on defaulted senior/unsecured bonds fell to less than 10%. Thus, even if OFHEO were to adopt a similar approach to Moody's recovery rate methodology, readily available information suggests that the GSEs' proposed recovery rate of 50% represents an overly optimistic rate if the Model is supposed to mimic a prolonged period of significant economic stress.

In addition, we disagree that defaulted bond prices serve as a proxy for recovery rates on credit enhancement obligations. Bonds and credit enhancement are two very different financial obligations with different sources for payments of recoveries. The recovery value of the bonds largely depends on the depreciated physical property and other corporate assets that are sold upon liquidation. In general, with the failure of a credit enhancement provider, the collateral typically consists of any remaining contingency and loss reserves and any stream of continued premium payments by third parties.

As we explain below, there are substantial portions of credit support currently benefiting the GSEs for which there may be zero recovery rates and potentially additional hidden expense obligations.

Freddie Mac's proposal for a 50% recovery rate on credit enhancement is based on its experience with recoveries on loans insured by TICOR/TIMIC, an MI company which went into liquidation in the late 1980s. GE believes that this example is inappropriate for two reasons: (i) the reason for the demise of TICOR/TIMIC was due to a massive fraud, not to mortgage loan performance driven by poor economic conditions; and (ii) the stream of remaining premium against remaining losses occurred in economic and financial conditions that were far better than those assumed in the stress test scenario. Consequently, any MI premium recoveries likely will be different in the proposed stress scenario than the 50% experienced by Freddie Mac under its unique experience with TICOR/TIMIC.

In addition to the historically specific TICOR/TIMIC example that makes any generalization imprecise, it is also important to note that not all types of credit enhancement have the potential for recovery as the more commonly accepted primary mortgage insurance policies. The GSEs benefit from approximately $4 billion in pool insurance coverage for which insurance premiums are generally paid in full up-front. Consequently, for a very large portion of the credit enhancement enjoyed by the GSEs there is zero recovery value because there is no remaining future stream of premium payments. Single premium primary policies, where premiums are paid up-front, are in the same situation.

We believe that a 50% recovery value for servicing rights in a recourse arrangement is even less supportable. Historically, during the mid-to-late 1980s when many seller/servicers developed poor performing portfolios, the GSEs seized the servicing rights of such companies prior to the servicer's eventual collapse. In many of these cases, GSEs were not only not able to sell the servicing rights to compensate themselves for the loss of recourse benefits. In fact, they had to pay new servicers higher servicing fees to enable the new contractors to service the troubled, high cost-to-service portfolios without operating losses. These examples also occurred in an interest rate environment that was less harmful to future streams of servicing revenues than the "down-rate" stress applied in the OFHEO model. Under a 600 basis point decline in interest rates, combined with substantial worsening in delinquency and default rates, it is doubtful that any positive value could be ascribed to such assets. In fact, one might argue that with the potential demise of many servicers, GSE expenses during the stress scenario should be increased to account for the need to pay new servicers to continue to service the rising amounts of seized servicing portfolios, let alone get a credit of 50%. Consequently we seriously question either the need or the appropriateness of the GSEs' proposal for a flat 50% recovery on credit enhancement benefits.

We urge OFHEO to maintain its position regarding spread accounts. Spread accounts start with zero capital and only gradually build up cash to absorb loss. In addition, once a stress scenario begins, the continued flow of the cash payments into the spread account becomes highly uncertain (which is why, we believe, OFHEO understood the weakness of this form of credit support under stress conditions and proposed no credit for cash flows after the start of the stress test). Although

Freddie Mac has argued in its comment that spread accounts and guarantee fee income are similar forms of credit loss absorption, spread accounts are substantively different than guarantee fees. The GSEs collect guarantee fees on all mortgages guaranteed, not just certain high-risk ones. As a result, it is appropriate to treat the income stream generated by broad based guarantee-fees as a source of cash that can, subject to prepayment and other assumptions, absorb credit risk.

In summary, the most significant problem with the recovery value concept is the creation of two unsatisfactory choices from a financial regulator's perspective. Acceptance of the recovery value concept without using arbitrary and unsupportable "recovery values" invites tremendous additional complexity, since the only prudent way to accommodate partial recoveries of defaulted credit enhancement would require significant detailed data gathering and analysis to determine potential insurance premium, servicing rights or spread account payment streams. This additional extensive modeling and data validation would surely push the limits of the GSE's desire for operational workability.

Alternatively, the use of an arbitrary fixed recovery rate (whether 50% or another percentage) could seriously overstate the recovery potential for credit enhancement and thereby materially understate the GSE's need for adequate capital. In effect, the "recovery rate" would become a form of disguised reduction of the OFHEO haircuts. Moreover, given that the bulk of credit enhancement benefits received by the GSEs are provided by "AAA" and "AA" providers (which already enjoy low effective discounts), there is marginal benefit to the concept. Under the GSEs' approach, the principal beneficiaries of the recovery concept would be lower rated entities, which, as the data demonstrate, have substantially higher default probabilities.

GE's Approach and Haircut Severity

We reject both recovery approaches, and renew our case for the simple, two-part approach presented in our Comment. Our approach uses one haircut table based on all, not selective, historical default performance data, and applies to all interest rate and credit risk mitigation counterparties. It is simple, distinguishing only between particular collateral (cash and Treasury securities) and external public ratings.

And, finally, our approach is consistent with OFHEO's haircut recommendation for non-derivative parties and the approach used by the Rating Agencies. Many commentators have complained about the severity of the haircuts, but they are not "too severe" in two respects. First, OFHEO's discounts are consistent with Rating Agency discounts. The Rating Agencies' assessment of the benefits obtained by a "AAA" rated financial guarantor (like the GSEs) from insurance and bank counterparties supports OFHEO's proposal, as follows:

Financial Strength or Credit Rating	**Moody's Assessment of Reinsurance or Financial Benefit Received**	**Standard & Poor's Assessment of Reinsurance Benefit Received**
AAA	100%	100%
AA	80-90%	75%
A	40-60%	50%
BBB	0%	0%

GE could have argued for no haircut for "AAA" counterparties using this Rating Agency approach, but did not. However, the Rating Agency approach provides no support for the arguments offered by the GSEs and the other commentators that the haircuts should be simultaneously compressed (reducing differences between rating categories) and lessened. Quite simply, that would be an imprudent thing to do.

Second, the Rating Agency approach would impose these haircuts immediately. Under the OFHEO haircut methodology, which we support, the discount ramps up from zero on day 1 to the proposed haircut percentage in the last month of the 10 year stress period. As a result, the effective discount is less than the stated one, since the bulk of the losses and credit enhancement received occur within the first 5-6 years. The maximum discount does not occur until the tenth year, so the haircuts are not nearly as severe as the Rating Agency discounts.

Thus, we stand by our original Comment, and strongly urge OFHEO to consider our recommended discount approach, which we believe is more defensible on a statistical and historical basis than either OFHEO's original proposal or those proposed by either of the GSEs. If recourse is an important aspect to the business success of an unrated institution, such an enterprise should take the necessary steps to become rated, to obtain third party support, and/or pledge appropriate collateral. To permit anything less creates a competitive disadvantage for all investment grade institutions who have accumulated sufficient capital to earn such rating.

GE also suggests that OFHEO not consider recovery rates for any of the counterparty haircuts unless OFHEO either wishes to use arbitrary recovery rates or significantly complicate the Model further with additional calculations of benefits relative to remaining streams of payments.

3. Various commentators, including GE, were correct in identifying that the Model overstated credit losses for high LTV loans and thus might discourage low down payment lending. This could make the GSEs' affordable housing commitments more difficult to achieve. However, we strongly recommend that OFHEO should disregard any housing policy concerns in making the necessary corrections to the Model. Model corrections should be based on adherence to the Act and establishing a stress test reasonably related to the BLE.

Many commentators criticized the Model for imposing capital standards that would be inconsistent with the housing policy goal of increasing the supply of affordable housing in the US. We strongly believe that there is no automatic conflict between having rigorous capital standards for the GSEs and increasing the supply of affordable housing. As we stated in our Comment (on pages 7 and 18) and elsewhere in this letter, meaningful capital standards are not a "tax on homeownership," and the GSEs have many credible alternatives to simply increasing interest rates as a means of offsetting any increases to their existing capital commitments. In addition, as the GSEs have recognized through their extensive consumer awareness activities, often only marketing, education and community group involvement is required in order to reduce perceived

barriers and biases associated with buying a home. Otherwise, these homebuyers are excellent prospects and do not require any special assistance.

Indeed, rather than a conflict, we believe meaningful capital standards will become a necessary prerequisite for the GSEs to meet their statutory obligations to underserved communities and low- and moderate-income homeowners. As we stated in our Comment (at pages 5 and 6), the GSEs provide stability and liquidity to the residential mortgage finance marketplace, which significantly assists in the general aim of keeping housing "affordable." The GSEs and other commentators have suggested that capital standards should be kept as low as possible to increase homeownership. We believe that this suggestion is short sighted. Recently, the US Treasury reminded members of Congress that GSE obligations are not guaranteed by the US Government, which resulted in considerable spread widening in GSE-issued debt securities. If this price volatility becomes more regular, the GSEs' ability to provide stability and liquidity could be impaired. The best way for the GSEs to reduce such volatility and continue to meet their stability and liquidity roles is to reassure investors by carrying sufficient capital, which would address the GSEs' stated concern of "linking capital to the economic risk of Fannie Mae and Freddie Mac as a whole."

In terms of specific Model issues regarding affordable housing, we think that the GSEs' "capital to economic risk" concept has considerable merit and is consistent with the three "benchmarks" discussed in our Comment (at pages 3-8). We agree with many commentators that the Model might inhibit low down payment lending, an important means of making housing affordable, by disproportionately penalizing high LTV loans from a capital perspective. Conversely, the Model's bias in favor of low LTV loans works against any effort to increase the relative proportion of high LTV loans purchased by the GSEs, since the GSEs receive a capital benefit disproportionate to the actual risk posed by low LTV loans. Thus, both halves of the problem (high LTVs too high, low LTVs too low) need to be addressed by OFHEO in the Model in order to avoid discouraging low down payment affordable housing activities.

However, we think consistency of the "capital to economic risk" concept requires caution as well. Few dispute the long-term goal of increasing the rate of homeownership in the US, but OFHEO is first and foremost a financial safety and soundness regulator. Thus, for example, while the GSEs might make housing more affordable for persons with impaired credit (and Freddie Mac's research maintains this category includes a substantial number of traditionally underserved borrowers), we stated in our Comment (at page 61) why we think certain riskier loan types should carry more capital than more traditional less risky loans. Currently, the Model benefits the GSEs, and not borrowers: the GSEs charge higher guarantee fees (and/or pay less) for these riskier loans, but the loans do not carry a higher capital charge. If "capital were tied to economic risk," and the loans carried the appropriate amount of capital, then the affordability debate could be presented more clearly. The borrowers could enjoy lower costs if the GSEs took the advice of Congress and accepted lower returns on such loans, or the GSEs could work with the residential mortgage finance community to reduce costs without passing the increased capital risk to the taxpayer. The GSEs work with HUD, their "mission regulator," to create achievable affordable housing commitments. OFHEO, while part of HUD, is not part of this commitment setting process, and should not become involved through relaxation of or embedded incentives in the

capital standards. There are other, more prudent ways in which the affordability challenge can be addressed.

Finally, since "affordable housing" is more than a homeownership issue, we want to comment briefly on the GSEs' multifamily activities. Our principal expertise is in residential mortgage finance and credit risk, but we would offer the following:

- Multifamily commitments constitute a relatively small portion of the GSEs' activities on a portfolio or MBS basis, as Table 8 demonstrates, but a disproportionately large part of the GSEs' affordable housing commitment. The GSEs could easily absorb any extra costs of linking capital to risk in the multifamily area due to the small size of this activity. As we have noted elsewhere in this letter, multifamily credit risk is more volatile than residential mortgage credit risk. Appropriately, the GSEs have recognized this increased risk, and therefore require a number of structural protections, including collateralization, participation by government entities and other forms of recourse. NPR2 simply assesses the creditworthiness of these structural protections, and some combinations of participants and protections will be better than others from a capital perspective. Rather than "unlink" capital to economic risk, the GSEs should use those combinations that yield the best results.

Table 8

Fannie Mae Portfolio and MBS Characteristics

Portfolio	**1999**	**1998**	**1997**			**1998**	**1997**	**1996**
Single Family (1-4)					**MBS Outstanding**			
GOVT INS	N/A	21,805	19,478		Fannie Mae Risk	674,295	615,320	580,138
CONV	N/A	380,745	284,753		Lender or Shared Risk	160,223	94,262	70,642
SF TOTAL	509,652	402,550	304,231		Total	834,518	709,582	650,780
Multifamily					Estimated % Multifamily	2.44%	2.21%	2.01%
GOVT INS	N/A	3,607	3,360					
CONV	N/A	8,358	9,087					
Multi Total	14,289	11,965	12,447					
% Multi	**2.73%**	**2.89%**	**3.93%**					
Total Portfolio	523,941	414,515	316,678					
Total MBS	961,000	834,518	709,582					
MBS in Portfolio	282,000	197,000	130,000					
Total Exposure	1,202,941	1,052,033	896,260					
Total Multifamily	30,857	26,054	25,256					
Total % Multifamily	2.57%	2.48%	2.82%					

- With mortgage revenue bonds, the higher the rating on the bond, the lower the haircut imposed on it. Linking capital to economic risk means acknowledging the possibility of default, so there has to be some haircut. However, a bond insured (or "wrapped") by a "AAA" rated financial guarantor would carry a lesser haircut, and additional structures involving the use of high quality collateral could reduce the haircut further (under our proposed approach). The haircuts cited by some commentators are the maximum haircut imposed gradually over a 10-year period, which will be less if the bond term is less, and proportionately less if the bond term is greater than 10 years, since there are no further discounts beyond the 10-year period. In addition, some commentators have included a portion of the 30% added for GSE management and operations risk, which we believe is inappropriate. Congress and OFHEO intended the 30% amount to address internal GSE risks, and not counterparty risks, which were analyzed and assessed separately.

- With low-income housing tax credits, some commentators have echoed the GSEs' complaint that NPR2 fails to amortize equity investments in partnerships that generate low-income housing tax credits. We find OFHEO's assumption reasonable from a modeling perspective, since the Model must reflect in part assumptions regarding GSE behavior in the event of a real (not modeled) prolonged national economic stress. From a national housing policy perspective, the GSEs would be under significant pressure to steady the course, including any existing multifamily commitments. If they did not, the prospect of continuing (formal and informal) government benefits could be imperiled, which might jeopardize the GSEs' ratings (and consequent funding advantages). We doubt the GSEs would risk their funding advantages in order to amortize certain equity investments in low-income housing tax credit partnerships, which probably would be illiquid and sold at a significant discount, if at all.

In summary, the GSEs play an important role in ensuring affordable housing for homeowners and renters, but OFHEO should not allow housing policy goals to weaken responsible capital standards either generally or through the creation of special exceptions for certain counterparties, transactions, or loan types. However, OFHEO should address the bias against low down payment loans and in favor of low LTV loans as an important step toward meeting the housing affordability challenge responsibly.

4. OFHEO should make adjustments to the Model that enhance its ability to fulfill the intent of Congress that the GSEs be subjected to a meaningful capital standard.

In our Comment and in this letter, we have made suggestions that would simplify the Model and OFHEO's regulatory tasks without sacrificing capital rigor. Thus, we have suggested a collaborative implementation process and a more simplified method of generating regular capital calculations that we believe is responsive to the GSEs' concerns and a responsible use of OFHEO's regulatory authority. In addition, our suggestion regarding the continuing use of a technical advisory board to assist in the timely assessment of new products and services represents a sound practice that will better accommodate innovation.

As we have noted, too, the GSEs' concept of linking capital and risk is similar to the three "benchmarks" presented in our Comment (at pages 3 and 4):

(a) ensuring that the credit loss standards represented by the Benchmark Loss Experience ("BLE") in the Model adequately protect the GSEs from the possibility of a significant default under the stress scenarios required in the Act;

(b) ensuring that the Model allows the GSEs to fulfill their two public purposes of maintaining liquidity and stability in the US residential mortgage finance marketplace and providing capital standards that encourage the GSEs to fulfill their affordable housing mandates; and

(c) ensuring that the Model adequately addresses the broad business activities of the GSEs.

This portion of our letter will not discuss all points of agreement or disagreement with the various commentators regarding their critiques of NPR2 and the Model, which we believe could be accomplished more efficiently and effectively within the context of a negotiated rulemaking. Since the supplemental comment period has been short, we will concentrate on suggestions made regarding matters in which we feel well-qualified to discuss, as follows.

Benchmark Loss Experience Changes

The GSEs offered numerous suggestions regarding the BLE credit loss standard in the Model, which was subjected to previous review and comment within the context of NPR1. The suggestions appear to fall within two categories: (1) criticism of frequency of loss assumptions that overestimate losses and fail to take into account improvements in underwriting approaches since the mid-1980s; and (2) criticism of severity assumptions that might be based on incomplete data, calculated incorrectly and do not account for the effect of loan seasoning.[11] Taking these categories in turn:

Up-Rate Scenario Losses

As they did in NPR1, the GSEs argue that the BLE should have lower credit losses in the "up-rate" scenario of a sustained 600 basis point increase in interest rates. [12] The GSEs noted that the Model adjusts the home price decline pattern somewhat to offset higher asset funding costs, but that the adjustment does not fully correspond to historical relationships between prices and 10-year Constant Maturity Treasury rates. Thus, they contend that home prices should be raised in the "up-rate" scenario by 75% of the increase in 10-year Treasury rates. According to Freddie Mac, such an adjustment would lower credit losses in the up-rate scenario "to a level 'consistent

[11] The GSEs also made a number of suggestions regarding the use of econometric modeling. We would observe generally that any changes OFHEO makes in individual components of the Model to reflect econometric modeling should be balanced by other changes to ensure that the net mortgage credit loss result under the interest rate stress scenarios is consistent with the BLE.

[12] At the center of their complaint is the Act's requirement of 4611(a)(1)(E) that states:
"If the 10-year constant maturity Treasury yield is assumed to increase by more than 50 percent over the average yield during the preceding 9 months, the Director shall adjust the losses in paragraphs (1) and (3) to reflect a correspondingly higher rate of general price inflation."

with' credit losses in the down-rate stress test." Freddie Mac also acknowledged that it made a similar comment in NPR1, only to have OFHEO respond that such a proposal would result in far too few losses for the up-rate scenario.

We disagree strongly with the GSEs' position regarding up-rate scenario losses. The Act requires that the Model's credit losses be "reasonably related" to the BLE, and not to the interest rate stress test. Further, we noted in our Comment (at pages 4 and 5), as did other commentators, that "after introduction of the interest rate stress the Model produces a significantly lower overall level of credit losses than the BLE in both the up and down rate interest rate scenarios."

We believe that our assessment of the BLE (prior to the introduction of the mandated interest rate stress) is similar to OFHEO's assessment that compares the BLE to an overall "AA+" (and "AAA" for the higher LTV buckets) Rating Agency standard. Freddie Mac presents its recommended inflation adjusted credit loss results (losses by LTV group) on page 59 of its comment. Using Rating Agency (specifically, S&P's) loss standards, as shown on Table 9 below, we find that the resulting up-rate losses are comparable to "BB+" standard losses by each LTV category.

Table 9

Up/Down Scenario Losses on New 7% Coupon Loans
As Proposed By Freddie Mac

	Down Scenario		**S&P Loss Assumption Standards By Rating Class**					**Effective Freddie Mac Loss Standard**
	No MI	**With MI**	**AAA**	**AA**	**A**	**BBB**	**BB**	
95	11.90%	**6.35%**	13.50%	8.10%	5.52%	3.92%	1.85%	A+
90	6.10%	**3.55%**	7.00%	4.35%	2.88%	1.98%	0.91%	A+
80	**1.60%**		6.45%	4.00%	2.80%	2.04%	0.99%	BB+
70	**0.50%**		5.25%	2.80%	1.76%	1.28%	0.62%	<BB
	Up Scenario		**S&P Loss Assumption Standards By Rating Class**					
	No MI	**With MI**	**AAA**	**AA**	**A**	**BBB**	**BB**	
95	4.40%	**2.18%**	13.50%	8.10%	5.52%	3.92%	1.85%	BB+
90	2.50%	**1.33%**	7.00%	4.35%	2.88%	1.98%	0.91%	BB+
80	1.10%		6.45%	4.00%	2.80%	2.04%	0.99%	BB+
70	0.62%		5.25%	2.80%	1.76%	1.28%	0.62%	BB

A "BB+" loss standard is simply unacceptable for a "AAA" rated enterprise.

As our first benchmark reflects, Congress and OFHEO intended the Model to capture the need for capital to cover potential credit risk losses on loans guaranteed as well as held in portfolio.

The interest rate risk portion of the stress test was to ensure that the portfolio funding strategies of the GSEs were not out of balance with the potential for severe changes in market rates. [13]

The GSEs' up-rate proposal has two problems. First, as noted below in our interest rate scenario discussion, the proposal exposes a serious potential analytical problem with the Model. Clearly, if credit losses are to be lowered when interest rates are sharply higher, then another less severe rate increase scenario might result in higher credit losses. Thus, if OFHEO accepts the GSEs' proposal, the GSEs could pass the Model on the basis of a remote possibility (the 600 basis point up-rate scenario), but could fail in a more realistic up-rate scenario.

Second, the Model sets capital requirements for all parts of GSE operations, whether portfolio or guarantee operations, and reducing mortgage credit losses under a rising rate scenario would diverge significantly from the manner in which capital is required of other mortgage risk takers, whether lenders or mortgage insurers, in the market today.

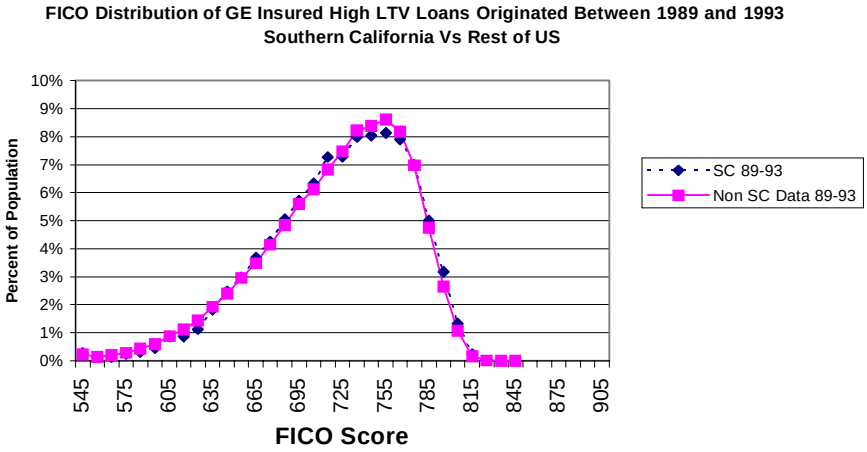
We suggested in our Comment (at pages 30-40) proposals for two different adjustments to the Model to not only improve the Model results by LTV group in terms of frequency and severity, but also to improve the fit by seasoned loans as well. Our proposals produce long-run loss results that are more closely related to the BLE benchmarks than either the current OFHEO proposal or that proposed by the GSEs. Without any adjustments, the Model would produce results that generally fall well below the "AA+" level suggested by the benchmarks. The Freddie Mac proposal would push these already low results for the up-rate scenario substantially lower, to levels that are uniformly below investment grade.

Impact of Underwriting Changes on Stressed Loan Performance

Both GSEs suggest that the BLE does not consider improvements in underwriting techniques and credit information made since 1986, which should reduce stress environment default rates. Clearly, there have been improvements, but it is unclear whether these improvements have served to reduce the frequency of default rates systematically. Based on our experiences in two regional recessions (Southern California and New England) which occurred on loans originated after 1986, we would counsel OFHEO not to reduce the BLE for underwriting improvements.

As we discussed in our Comment (at pages 65-66) and other commentators have noted, much of the change in underwriting techniques has been driven by the increased use of FICO scores (individual borrower credit risk rankings developed by Fair Isaac & Company). The higher the score, the lower the degree of credit related risk that is attributed solely to the borrower. These scores have proven to be an efficient means of grading loans by quality, and mortgage scoring systems developed by GE and other market participants have developed even more predictive power. However, default rates of a magnitude similar to those of the BLE are clearly driven by economic forces and only in part by credit related factors. That is, credit scores and even mortgage scoring systems (which include market-related factors) predict borrower performance

[13] Our conversations with the major Rating Agencies confirmed that their mortgage credit default estimates are independent of interest rate changes because such default rates are more the product of increasing unemployment than interest rate changes.



well in normal economic times, but **their predictability remains untested under severely stressed, prolonged economic downturns**.

To illustrate this fact with FICO scores, we have shown a FICO score distribution in the Figure above for GE-insured high LTV loans on borrowers for loans originated in Southern California between 1989-1993, our worst regional book of business since the West South Central of the early to mid 1980s ("WSC," the basis for the BLE). The other distribution represents the rest of the US for all loans insured by GE for the same time period. There is little difference in the FICO distributions. However, there was a substantial difference in loan performance.

Despite the very strong similarities in underwriting risk profiles, GE's average default rate on fixed rate 1989-1993 Southern California 90% LTV loans exceeded the BLE assumptions and GE's average default rate on fixed rate 95% LTV loans fell just short of BLE levels. The rest of GE's insured loans performed better than long-run averages. The poor loan performance results of our Southern California books also occurred with mortgage coupons well below those on loans during the BLE (despite the Model's estimates that loans with lower coupon rates should perform substantially better than the BLE).

Both the BLE and Southern California performance numbers resulted from stressful economic conditions. While new underwriting techniques are indeed helpful in explaining differences in the loan performance of various pools of loans under more average economic conditions, they are less helpful in conditions similar to those experienced in the WSC or Southern California. Congress required OFHEO to use the BLE as a worst case scenario. Until empirical evidence develops regarding the loss mitigation value of underwriting changes in a national or regional economic downturn similar to the WSC, OFHEO should make no underwriting-related adjustments to the BLE.

BLE Severity Data

Freddie Mac includes in its comment the results of a research effort by Research Triangle Institute regarding the appropriateness of the weighting of the samples used. The RTI study concluded that the loss severity numbers used to create the BLE are 5.27% too high due to missing data and inappropriate-weighting by state distributions. Since we have not had access to the actual data used by OFHEO, we cannot determine whether unintentional biases are present in the BLE. In addition, we agree that the choice of the "ALMO" (Arkansas, Louisiana, Mississippi and Oklahoma) configuration should not be retained for the BLE if, based on proper re-weighting of

the numbers, re-estimated default and loss rates are lower than another geographic combination.[14] To ignore a higher loss configuration would not be consistent with the requirements of the Act.

However, we disagree strongly with Freddie Mac's conclusion that OFHEO should throw out its work to date on the BLE and begin again. The Model's BLE configuration is not fixed forever, but will develop dynamically over time. OFHEO should consider Freddie Mac's criticisms (and those offered by others) for the next generation of the Model and, if more complete data are available that support a worse default experience, then that version should be substituted for the current BLE. OFHEO's efforts were reasonable. The advantages of timely implementation of a risk-based capital regulation in terms of safety and soundness by using the proposed ALMO configuration as opposed to further study are obvious.

Loss Severity Estimates and Seasoned Loan Severity

Both GSEs argued that OFHEO's loss severity formula is not sufficiently sensitive to changes in home values over time or to the interest rate scenarios used in the stress test, resulting in a poor correlation with actual stress test cases. We agree, as we discussed in our Comment (at page 29). The addition of a sizeable constant term to the loss severity equation (equal to roughly 20% of the targeted loss severity rate) was used to better fit the average loss severity to the average of the BLE loss severity benchmarks. Not surprisingly, with such a large portion of the loss severity fixed at a constant level, the correlation between actual loss severity cases and estimated levels on individual loans was poor.

Thus, we suggested that the severity formula, without the added constant term, would work better if a more appropriate price decline assumption were used in describing the stress test conditions. By adopting this suggestion OFHEO will find that estimates from this revised formula do track actual loss severity substantially better than the previous formula. In addition, the influence of changes in mortgage rates over time together with the different stress scenarios will be more accurately portrayed, thereby meeting the concerns expressed by the GSEs on this topic.

Our suggestion addresses another concern raised by the GSEs regarding seasoned loan severity. In running simulations (with our proposed changes to the price decline assumptions and removal of the constant term), we observed that the Model tracked loss severity by seasoned loans in a manner that would be consistent with seasoned loan price appreciation. Seasoned loans with greater price appreciation prior to the start of the stress suffered lower levels of loss severity than new loans. Consequently, as long as the loss severity is free of substantial arbitrary constants and is using our proposed price decline assumptions during the stress, seasoned loan loss severity will be properly accounted for.

[14] In view of data problems encountered, it is not clear to us why the Texas market was not included in the configuration given the very high default rates in many of its MSAs and the sharp decline in repeat sales home values in Austin, Houston, and San Antonio. We do not understand why the Texas market should be considered "an outlier or atypical region with data problems or quirks requiring adjustment," as Freddie Mac suggests in its opposition to considering alternate geographic configurations.

In contrast, Freddie Mac has proposed fixing loss severity of seasoned loans at 20% less than loss severity on new loans. This simple approach has two significant shortcomings. First, unless we have misunderstood their proposal, it would appear to be contrary to their best interests in a rising price environment. In addition, Freddie Mac's proposal for a fixed discount from new loan loss severity would severely underestimate the need for additional capital in a flat or falling market, raising concerns for proper safety and soundness as well.

Second, the Freddie Mac proposal appears to diminish the role of the home price index ("HPI") in determining the loss severities of seasoned loans. We have expressed concerns in our Comment (at pages 41-47) regarding the use of an unadjusted HPI before and during the stress period, and suggested a two-year lag to dampen the pro-cyclical capital volatility of the HPI in pre-stress periods and substitution of a Rating Agency price decline for the HPI during the stress to capture behavioral phenomena such as foreclosure sales. We continue to believe that our recommended approach is both prudent and easy to implement.

Cross-Subsidization

As we and other commentators have noted, OFHEO created certain unintended effects in NPR2 and the Model in its effort to implement the Act. One such unintended effect concerns the cross-subsidization of risk not only between various loan types (*e.g.*, low and high LTV loans) but also between business lines (*e.g.*, guarantee activities versus portfolio lending). Unlike other asset specific capital requirement standards utilized by regulators, the Model would assign levels of "negative capital" to certain types of assets which would result in lower absolute levels of capital in the aggregate (through the addition of more such assets carrying "negative capital requirements" even though economic risk is being added). Adopting our suggestions to reflect low LTV risk more accurately in the Model will reduce some, but not all, cross-subsidization between products. Freddie Mac has raised the "negative capital" issue in its comment, referring to it as a "counter-intuitive result" that is "clearly inappropriate." We suggest that OFHEO eliminate any negative capital results that the Model produces.

Cross-subsidization occurs between business lines as well as products. OFHEO decided to apply the interest rate stress test to the MBS guarantee operations as well as portfolio operations. The value of applying the interest rate stress to portfolio activities is clear: Congress intended no recurrence of the mismatch in portfolio funding duration Fannie Mae suffered in the early 1980s. However, we see no reason to extend the interest rate stress test to MBS guarantee operations for which there is no funding risk. Under the two extreme interest rate scenarios, the Model produces two very different streams of guarantee income against estimated credit losses that fall below BLE standard levels. Using an interest rate assumption similar to the decline in rates during the BLE stress period (1983-1993), MBS credit losses would more closely resemble BLE losses. Given the difference in result, and since the major risk to the GSE MBS guarantee operations is not related to funding, but credit risk, why should this operation be subject to a less rigorous credit standard simply through application of the interest rate stress?[15] As a consequence

[15] Rating Agencies in their treatment of MI companies and other guarantors of credit default risk do not vary their default risk assumptions by interest rate scenarios, unless the particular asset's risk of default is directly related to changes in market rates. Rating Agencies typically view ARM loans as being substantially riskier than fixed rate

to subjecting the guarantee operation to an "up-rate" interest rate risk scenario, the higher stream of MBS guarantee income generated by the slower loan prepayment speeds requires roughly half the amount of capital required under the down scenario. Thus, by combining the capital requirements of both portfolio and MBS operations, overall GSE capital requirements are substantially reduced for what should be considered a very troubling economic scenario.

We have made two specific suggestions in our Comment to remove such counter-intuitive and inappropriate results. Both recommended solutions will produce projected credit losses across LTV categories that are consistent with the LTV credit losses observed in the BLE.

Additional Interest Rate Scenarios

We agree with other commentators regarding the importance of running additional interest rate stress scenarios beyond the two scenarios required by the Act. Specifically, we are concerned that the statutorily specified interest rate stress tests will not result in the best measure of a GSE's ability to survive a prolonged national economic downturn. Thus, in conjunction with our suggestion that OFHEO devolve the responsibility of operating the Model to the GSEs, we urge OFHEO to require additional stress scenarios using other interest rate paths, including paths that are (i) less severe, (ii) more volatile in their changes over the ten year period, and (iii) include different yield curve assumptions. If any of these additional paths generate higher capital standards, then we suggest that OFHEO require the GSEs to hold capital consistent with those levels.

Structured Loan Transactions

We expressed concern in our Comment (at pages 47-50) regarding the risk implication of encouraging structured loan transactions (*e.g.*, 80/10/10s). Freddie Mac offered three observations regarding structured loan transactions. First, Freddie Mac argued from a risk perspective that such loans in a structured transaction are adequately represented in the BLE and need no special risk-based capital treatment. It further argues that, to the degree these loans have increased as a market factor since the BLE, improvements in underwriting have eliminated any additional risk. Last, Freddie Mac argues that it is not possible from loan documentation to differentiate such loans from true single lien transactions.

We disagree with Freddie Mac's observations. First, structured loan transactions, in contrast to second mortgages placed on homes well after origination, were not a meaningful market factor during the BLE (and thus are not represented in the BLE). Second, no underwriting improvement alters the increased risk stemming from the higher combined LTV, which is why bank regulators treat structured loans as a single one for determining the LTV because these loans perform like higher-risk high-LTV loans. Finally, GSE-approved closing documents require that all sources of funds needed for closing are represented, including second lien financing. This information permits the GSEs to determine if a second lien has been originated with the first

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loans in an up-rate scenario. However, in a depression scenario where interest rates are generally assumed to be falling, ARM loans are generally assumed to perform very similar to fixed rate loans.

lien.[16] If Freddie Mac has some operational issues tracking such information, OFHEO should require those operational changes be made given the substantial impact on default risk. Otherwise, the "operationally workable" excuse could be used whenever a GSE did not want to link capital and risk.

Variation of GSE Expenses Under The Two Stress Scenarios

We discussed GSE operating expenses briefly in our Comment (at page 59), but were impressed by the more expansive offerings by the GSEs and other commentators. Both GSEs commented that OFHEO's decision to model GSE expenses as a variable charge against the outstanding loan balances of both loans in portfolio and MBS outstanding inaccurately depicts their cost structures and therefore distorts risk. The GSEs argue that a large portion of the cost associated with maintaining and servicing existing company balances is relatively fixed, and thus would be largely unaffected by dissimilar mortgage liquidation rates in the two stress test scenarios. In particular, Fannie Mae estimated that its capital requirements in the up-rate scenario could be as much as $2 billion higher than the down-rate scenario due solely to the treatment of expenses as a variable-cost component.

Both GSEs have offered a counter-proposal that would divide their expenses into two components, one for fixed expenses and the other variable. Freddie Mac suggests that the fixed cost component should be set at a dollar amount equal to 1.75 basis points per year of unpaid principal balance at the start of the stress. The variable cost would be set at 2 basis points per year of unpaid principal balance. Fannie Mae concurs with the variable cost of 2 basis points times the average balance, but recommends a lower fixed cost percentage of 1.5 basis points. Both assert that under either stress situation that they would pare down their expenses by laying off origination sales staff and reducing other new business expenses. In terms of capital requirements, Freddie Mac notes that its proposal would increase capital requirements somewhat in the down scenario, but would provide a more accurate treatment of expenses for the up-rate scenario.

We suggested holding the level of expenses constant in our Comment, but the GSEs' conceptual approach is well taken. However, based on comments prepared by the MBA as well as consequences to the GSEs relating to the impact of severe economic situations on seller/servicers, we believe that the GSE proposal requires further adjustments. We do not think the GSEs' expense proposals are achievable under the stress conditions assumed in the Model for several reasons.

First, based on GSE financial reports as presented in OFHEO's "1999 Report to Congress", GSE expenses to outstanding MBS and portfolio have averaged over 7 basis points for the past 10 years. The lowest ratio for Fannie Mae, which also has the largest combined base of loans, was 6.6 basis points in 1991 and 1992, with a rate of 6.7 basis points in 1998. Freddie Mac's lowest ratio of expenses to outstanding loan exposure was 7.0 basis points in 1995. If we use Fannie Mae's formula, expenses to outstanding would be 3.5 basis points in the first year of the stress test, almost half of its lowest expense ratio in the last ten years. Freddie Mac's formula would

[16] Only second mortgage liens placed well after a first lien has been originated are currently unknown to the GSE.

require only 3.75 basis points against its ten-year low of 7 basis points. Thus, the GSEs' proposal would generate a very generous decline in expenses at the earliest stage of the stress period.

Second, the MBA in its comment noted that the assumption of an operating expense decline was inconsistent with the experience of a sample of stressed banks. Rather than a decline, "operating expenses typically rise during the first six months to one year (and sometimes longer) of a crisis or stress situation, [since] banks often add additional resources or require special efforts to support crisis decision making. During this period, standard operations often remain unchanged. Several months to several years are often required to establish the depth of the business cycle and the new portfolio structure leading to the reduction in expenses." Thus, "GSEs might engage a considerable number of consultants, hire additional staff, and take other defensive actions to help mitigate the effects of a stress period while continuing operations." And, given the centrality of the GSEs to US housing policy, it is unlikely that sales staff could be reduced as quickly as the GSEs would like to assume for Model purposes.

Indeed, both GSEs increased staffing in their property disposition units to handle the rise in regional defaults suffered in the mid-1980s. A situation in which defaults similar to those suffered in the BLE occurred nationally would require a larger staffing-up in this particular operations area. And, in line with MBA's comments regarding a time lag prior to determining a change in operations, the GSEs would still have to contend with lay-off and severance charges for sales and new business staff in addition to retraining or hiring new loss mitigation specialists.

The Rating Agencies recognize the concept proposed in the MBA comment. In S&P's stress test for rated MI companies, S&P uses two measures to cover expenses of a run-off exposure. The first assumes a decline in some expenses directly related to the decline in outstanding exposure. The second increases loss adjustment expenses through use of a 1.25 multiplier of the coverage rate times the defaulted loan balance. This assumption is substantially higher than the 1.1374 multiplier used by OFHEO in assessing MI benefits in the WSC stress experience.

We recommend that OFHEO adopt the concept proposed by the GSEs to estimate stress expenses through the combination of a fixed cost expense ratio based on the loan balances at the start of the stress plus a variable cost expense ratio based on balances over time during the stress. However, the combined expense ratios should more closely match expenses observed in the year prior to the start of the stress, and the fixed expense portion of the formula needs to consider the increased expenses referred to by the MBA.

30% Operational Adder

As we noted in our discussion of recovery rates for defaulted credit enhancement providers, many seller/servicers will find it increasingly difficult to survive over the life of the stress test. The GSEs' experience with the seizure of servicing rights of defaulted seller/servicers has been that the GSEs often have to pay incremental servicing compensation to a new seller/servicer to take over such seized servicing to offset the higher operating costs associated with servicing a poorly performing portfolio. Given both the extreme performance problems of portfolios in the stress situation and a market environment where mortgage rates have declined as much as 600 basis

points below the current mortgage coupons of such portfolios, one would expect that a large number of seller/servicers would indeed fail, and that there would be additional costs to the GSEs to ensure the continued collection of funds and management of delinquencies and foreclosures. Non-failing seller/servicers would require higher sub-servicing fees if they agreed to take on the business at all.

This particular aspect of GSE operations is not covered by the Model currently, and we believe that the 30% management risk adder, often cited as a catch-all, will be severely stressed to cover this additional operational risk. The 30% factor assumes that the Model already covers all identifiable cash flows and risks.

Assuming that the GSEs have the flexibility to secure sufficient credit offsets and interest rate hedges to maintain risk-based capital at near minimum levels, the 30% management risk adder (based on the overall mix of portfolio vs MBS as of the end of 1998) adds only 37 basis points. With most rated seller/servicers falling between "A" and "BB" and the large concentration of unrated seller/servicers, a failure rate between 20-60% for seller/servicers is probable. If these failed institutions cover 65% of their proportionate share, 13% - 40%, roughly 27% of all servicing will need to be seized and placed with a new servicer. If the cost of servicing these portfolios is twice the normal expense, then the GSE will need to spend an additional 6.75 basis points per year (as a percent of the overall loan balances) to cover this. The present value of this stream in the down rate scenario might be more than half of the amount covered by the 30% adder. Thus, due to the potential high level of incremental servicing costs that the GSEs might encounter to find replacement servicers in a stressed environment, we caution OFHEO to be very conservative in allowing items to be included in this important catch-all category.

5. OFHEO should implement NPR2 in a timely fashion, and any increase in capital beyond current minimum capital levels does not need to raise the cost of homeownership. Further, such a capital increase might benefit the GSEs in the future.

One final note on the importance of implementation, costs and benefits. We strongly urged OFHEO in our Comment (at page 11) and in this letter to adopt NPR2 and the Model immediately with our suggested adjustments and enhancements. By "immediately," we meant as soon as practically possible. OFHEO in its role as the safety and soundness regulator should not significantly delay implementation through further protracted rulemaking and analysis. OFHEO will face increasing scrutiny and pressure regarding why the final regulations expected by Congress within 18 months have taken much longer. That is why we, along with other commentators, continue to urge timely adoption and implementation of NPR2 and the Model.

We have stated consistently in our Comment and in this letter that any proposed adjustments and enhancements to NPR2 and the Model that raises capital requirements beyond minimum capital levels can be made without raising the cost of homeownership. If the GSEs wish to pass through the costs of any change from their current arrangements, then costs will increase. However, the GSEs don't have to, and indeed have the financial and regulatory flexibility to maintain mortgage rates and absorb any increased capital requirements.

Finally, we would like to comment on the possible macroeconomic impact of NPR2. At Fannie Mae's request, the consulting firm of Ernst & Young prepared a detailed analysis (attached to Fannie Mae's comment letter as Appendix IV) of the possible impacts of NPR2 on the GSEs. The following is a brief synopsis of E&Y's "Possible Responses of the GSEs to the Risk-Based Capital Regulations" (at pages 5 and 6 of the attachment):

- "…additional constraining capital requirements are similar to a tax on every mortgage a GSE purchases".
- "…they (the GSEs) may respond by purchasing fewer loans."
- "…may respond to the imposition of RBC by changing the distribution of assets in their portfolio from "high risk" to "low risk" assets."
- "…could also respond to the RBC requirements by raising new capital."
- "…could also attempt to pass on the additional costs on binding RBC requirements as higher fees and other charges on originating institutions."

We agree there are many possible impacts and responses to NPR2. However, we think that the Ernst & Young analysis dwells too much on disadvantages and costs, and not enough on the possible benefits of NPR2. Consequently, we would like to add an additional scenario for OFHEO to consider.

Recently, there have been indications from the US Government that it is considering decreasing the implicit government guaranty from which the GSEs presently benefit. As a result of these indications, investors concerned about the reduction in any implicit government backing have reduced some of their holdings in GSE debt, causing GSE debt instruments to experience a widening in spreads (the difference in yields between GSE and Treasury debt). Although this increase in the GSEs' cost of financing may be only temporary, it invites one to consider the long-term benefits of setting prudent risk-based capital standards.

If the government implicit guaranty is reduced and GSE debt costs increase significantly and permanently (since they are viewed as stand-alone concerns), the GSEs might increase mortgage rates in response. We believe that the best way for the GSEs to maintain or lower their debt costs under this scenario (or any other scenario) and avoid raising mortgage rates would be to carry more capital. This would alleviate investor concerns driven by any reduction in the implicit guaranty and the highly leveraged position of the GSEs. Thus, any significant increase to the GSEs capital position would be positively viewed in the market and could result ultimately in a lower, more stable cost of funds for the GSEs. This lower cost of funds could more than offset any increased capital costs, thus resulting in a potential decrease in mortgage rates.

As we have stated previously, the GSEs provide stability and liquidity to the mortgage market. We believe that this stability and liquidity would be enhanced by establishing prudent risk-based capital standards in a timely fashion.

We look forward to working with you and your colleagues to finish the task before us.

Sincerely yours,

James C. Zollo
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