

April 14, 2000

Mr. Alfred M. Pollard  
General Counsel  
Office of General Counsel  
Office of Federal Housing Enterprise Oversight  
1700 G Street, N. W., 4thFloor  
Washington, D. C. 20552

Dear Mr. Pollard:

This letter provides the comments of the Mortgage Insurance Companies of America (MICA) on the comments provided to OFHEO by others on the pending GSE risk-based capital regulation. We appreciate OFHEO's interest in receiving additional views and welcome the chance to comment on several major suggestions for changes to the proposal sent to OFHEO by Fannie Mae, Freddie Mac, the Consumer Mortgage Coalition (CMC) and other interested parties.

1. Comments urging narrowing of haircut spreads between AA-rated and BBB/ below investment grade credit enhancement counterparties should be rejected.

MICA has reviewed the Fannie Mae and Freddie Mac recommendations regarding narrower spreads and reductions in the haircut levels and we find the arguments unconvincing. MICA reaffirms its support of the OFHEO proposal as it concerns haircuts for credit enhancers, subject to the modifications we set forth in our comment letter submitted on March 10, 2000. The appendix attached to this letter provides a detailed analysis of our critique of the GSE recommendations. As is shown in Table 2 of the appendix, the GSEs presented incomplete data from the study they used in arguing for reduced haircuts and lower spreads, omitting from their

presentation data from their own sources that argued in fact for wider spreads. MICA's own recommendation, as presented in our original comment, is reinforced by the study cited by the GSEs, once all of the omitted data are considered.

Strong policy arguments, in addition to these important technical points, support a wider spread between BBB-rated and below BBB/unrated counterparties than that suggested by the GSEs. To the extent that the OFHEO rules fail to reflect the real risks of lower-rated counterparties, then a perverse incentive for the GSEs to arbitrage the capital rules will be created. If the capital costs of using an unrated counterparty are no greater than those, for example, of a BBB-rated one -- even though a complete review of the data show that unrated counterparties are far greater default risks -- then market pressures will result in the GSEs using the lowest possible rated or unrated credit enhancement counterparty.

Failing to properly capture the real default risk of different counterparties would lead OFHEO to make the same mistake the Basle committee is now attempting to fix with its proposed revisions to the risk-based capital rules for banks. There is ample evidence from the banking sector that crude risk weightings lead to higher risk-taking. OFHEO should ensure that its haircuts are large enough to prevent the GSEs from engaging in risk arbitrage.

2. Mortgage credit risk derivatives should not be given any credit, at least for now. The GSEs' proposed credit treatment with very favorable haircuts for credit risk derivatives should not be implemented.

In our initial comments, MICA detailed numerous reasons why credit derivatives should not now be included in the OFHEO risk-based capital rules. After reading numerous comments on this issue, we believe our recommendation stands; OFHEO should not now recognize credit

derivatives and allow any credit for them in its risk-based capital rule. When and if these instruments prove themselves in an economic downturn, OFHEO should propose credit treatment and appropriate haircuts for them in a separate rulemaking. At the least, we urge OFHEO not to act until the bank regulators have established a method of treating credit risk derivatives and this approach has been tested in the marketplace.

The GSEs proposed a different approach, arguing that not only should credit be given for credit risk derivatives but also that the credit risk transfer is so complete that they warrant no hair-cut at all. They suggest that the only risks germane to credit derivatives are operational, and that these are adequately captured in the 30% operational risk add-on to be implemented in the RBC regulation. However, this approach ignores the very substantial credit risks inherent in mortgage credit derivatives. Credit risk derivative counterparties not only may not wish to honor their obligations -- the legal aspect of operational risk -- but they may also simply not be able to do so as the result of adverse market conditions, under-capitalization, or other factors.

3. MICA believes that structured mortgage transactions can easily be detected from loan documentation and that the elevated risks of such transactions should be captured by the capital rules.

On page 85 of its comment, Freddie Mac argues that it is not possible from loan documentation to differentiate structured mortgage transactions (e.g., 80-10-10s) from true single lien transactions. MICA strongly disagrees. Lenders are required to notify the agencies if additional liens are being placed upon a home at the time the mortgage is sold. This documentation readily permits the GSEs to determine if a second loan has been originated with the first lien. Only seconds placed well after a first lien has been originated are currently unknown to the GSE since, of course,

any such seconds are taken out well after the initial loan has been sold to the GSE.

As noted in our first comment letter, MICA believes that structured loan transactions present greater risks to the GSEs that not only can, but should, be captured in the RBC regulation. Bank regulators treat structured loans as a single one for determining the LTV because these loans perform like higher-risk high-LTV loans. OFHEO should do the same.

Freddie Mac also asserts that loans in a structured transaction are adequately represented in the BLE and thus 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. MICA disagrees. There is no evidence to support these arguments.

First, we do not believe that structured loan transactions, in contrast to second mortgages placed on homes well after origination, were a meaningful market factor during the BLE. Second, no improvement in underwriting can alter the fact that risk rises inexorably with LTV. There is no evidence of improvements in underwriting that mitigate the relative risk of high-LTV lending.

4. As we noted in our response to the first Notice of Proposed Rulemaking, the BLE is a valid, as well as mandated, target for the stress test and is supported by MI industry experience. MICA continues to support the BLE as a stress test and neither GSE has proven why the BLE would be inappropriate.

The GSEs have proposed numerous revisions to the RBC stress test that would undermine the BLE and result in a lower level of stress test-related mortgage losses. The OFHEO Model already produces a lower level of credit losses than the BLE under the interest rate stress scenarios. Accepting the GSE revisions would only lower an

already too low level of Model-produced credit losses under the interest rate stress scenarios. Freddie Mac notes that the Model overstates the default rates associated with high-LTV loans, but fails to note that the model significantly understates the default rate on low-LTV loans. Fannie Mae argues that underwriting changes since 1986 generally invalidate the BLE, recommending numerous changes to the Model to reflect what it believes to be better stress scenarios derived from econometric models.

MICA does not believe that there is any evidence that the many changes in underwriting techniques adopted by mortgage lenders since 1986 have invalidated the BLE assumptions. While there has been no national downturn since the BLE was established, the California and New England regional recessions in the early 1990s produced mortgage default and severity rates similar to the BLE. Therefore, there is no evidence that any changes in underwriting will truly alter mortgage loss experiences in a stress scenario. The law mandates use of the BLE as a worst-case scenario. Unless or until hard evidence during stress periods indicates the real loss mitigation value of underwriting changes since the BLE, OFHEO should honor its mandate and calibrate the mortgage credit loss portion of the risk-based capital rule to the BLE.

Any changes OFHEO makes in individual components of the stress test 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.

5. MICA supports OFHEO's proposed treatment of spread accounts which would give no credit for cash flows after the start of the stress test.

In their comments, the GSEs argue that spread accounts should enjoy favorable capital treatment because these accounts arguably support affordable housing and because of the cash flow associated with them. Freddie Mac, for example,

argues that spread accounts and guarantee fee income are equivalent in terms of credit loss absorption.

MICA believes that spread accounts are not an equivalent form of credit risk mitigation to true third-party coverage and thus should not be given any credit except for the actual account balance at the start of the stress test. First, spread accounts start with zero capital and only gradually build up cash to absorb loss. It makes no sense to treat them the same as an adequately capitalized third-party credit enhancer that is ready and able to absorb the full loss from its first effective date. Second, once a stress scenario begins, the continued flow of the cash payments into the spread account becomes highly uncertain. OFHEO clearly understood this and structured the RBC rule accordingly.

Additionally, spread accounts do not support affordable housing since they raise the cost of a mortgage to the borrower. In contrast to MI, the extra interest payable by the borrower that generates the spread account is not cancelable. Borrowers must pay for the additional cost of the spread account over the life of the loan, which increase their cost of home ownership. OFHEO should reflect Congress' concern that mortgage insurance be cancelable and not provide any capital incentive for the use of alternative forms of credit enhancement that are not cancelable, especially since these do not provide equivalent credit risk mitigation.

Spread accounts are substantively different than guarantee fees. The latter are received from all mortgages the GSEs purchase, not just certain high-risk ones. As a result, it is appropriate to treat the income stream generated by g-fees as a source of cash that can, subject to prepayment and other assumptions, absorb credit risk. Spread accounts, in contrast, are intended to substitute for other, more traditional, forms of credit enhancement on higher risk loans and thus should be evaluated for capital purposes in comparison with the

stress scenario mortgage credit risk absorption ability of more traditional credit enhancements.

Finally, to accurately model the impact of spread account financing as proposed by the GSEs would significantly complicate the Model. In order to properly model the spread account all loans would have to be segregated by individual pool, thus adding a substantial degree of complexity and detail to the Model.

6. We support the comments of others who agreed with our concern that changes are needed to the Model that eliminate the possibility for cross-subsidy within the RBC regulation.

We agree with the CMC that the OFHEO rule should not permit a cross-subsidization between credit- and interest-rate risk related capital. Indeed, Freddie Mac appears to agree. On page 111 of its comment, with regard to multi-family housing, Freddie Mac states that, "...negative capital requirements are clearly inappropriate..." As noted in our comment letter and cited by the CMC, no other capital rules of which we are aware permits cross-subsidization that can, in fact, result in zero or even negative capital despite the assumption of economic risk.

In conclusion, MICA would like again to express its support for the proposed OFHEO risk-based capital rule with the modifications we set forth in our earlier comment letter. While we believe, as stated in our initial comment, that the proposal requires certain refinements, the structure proposed is a sound one. It is vital that OFHEO move ahead as quickly as possible with a final rulemaking to bring these huge enterprises under a prudent risk-based capital regime.

Sincerely,

[Signed: Suzanne C. Hutchinson]

Suzanne C. Hutchinson

## **Appendix to MICA Comments Regarding Discounts of Counterparty Benefits**

In their comments regarding OFHEO's proposed schedule of discounts on benefits received from credit enhancement counterparties, both GSEs concluded that the discounts were too severe in light of historical corporate bond performance. They also cited OFHEO's lack of consideration of potential recovery value on mortgage insurance benefits and servicing incomes as further potential offsets to the loss of potential offsets to loss.

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", as evidence that actual corporate default rates were never as severe as assumed by OFHEO in its stress test assumptions.

Based on these observations the GSEs each propose different approaches for estimating a new schedule of discounts, but both conclude that counterparties with less than investment grade ratings and any counterparty not carrying a rating be granted the same discount as a "BBB" counter-party.

More specifically, Freddie Mac proposes a schedule that is three times the average historical default rate by corporate rating category based on averages from 1970-1999. Freddie Mac asserts that its own experience suggests that a 50% recovery rate is applied to further adjust the default rates. This proposed discount schedule would be applied only to the "Down-Rate Scenario". For the "Up-Rate Scenario," in view of Freddie Mac's assumption that both defaults and losses would be substantially lower, it suggests that discounts be reduced an additional 30%.

Based on its interpretation of historical corporate default rates, Fannie Mae opines that OFHEO's counterparty risk haircuts far exceed any historical worst case. Fannie Mae correctly notes that Railroads appear to have suffered substantially higher default rates than any other industry and may perhaps have been inappropriately rated prior to the

beginning of the Great Depression. Fannie Mae says that Industrial corporate defaults may be a more appropriate indicator and recommends a discount of 3% for "AAA", apparently because corporate issuers rated "AAA" in 1983 had a ten-year default rate of 3.02%. The remaining Fannie Mae recommended discounts by rating category are all arbitrary, but reflect a 50% recovery rate assumption. It strongly suggests that this recovery assumption be applied to credit enhancements where the borrower's payments for such coverage could be assumed by the GSEs. The GSE also claims that a seller/servicers' mortgage servicing rights serve as another form of offset and proposes that the value of such rights also be assumed to provide a 50% offset to loss of credit enhancements provided by such entities.

The GSE-proposed maximum discounts by rating category schedules are given in Table 1 below.

**Table 1. GSE Proposed Maximum Counter-Party Discount Schedules**

<b>Rating Category</b>	<b>Fannie Mae Proposal</b>	<b>Freddie Mac Proposal</b>	<b>OFHEO Proposal</b>
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%

### **Historical Default Rates**

Both GSEs made extensive references to the 1958 W. B. Hickman study that covered corporate bond default rates from 1900-1944. However, the references both GSEs make are to Table 36 on page 190 of the Hickman study. This table does indeed cover quadrennial default rates by individual investment grade categories. However, Table 36 references only large issues and not the entire universe of issues. Small issues, according to numerous other exhibits in the study, suffered substantially higher default rates within the same rating categories. Moreover, the assertion that the GSEs were able to convert four-year rates into ten-year default rates cannot have been accomplished without having access to ratings transition 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. Since the Hickman study lacks the necessary transition detail, we find the GSEs calculations of estimated 10-year default rates to be unreliable.

Most troubling regarding the GSE quotations of the Hickman study is the lack of any mention of the performance of below investment grade entities and information on the performance of unrated corporate issuers. Indeed, on the page of the Hickman study previous to the one referenced by both GSEs there appears a Table 35 which clearly shows the relationship between large and small issues and especially between investment grade, non-investment grade and issues with no rating. Excerpts from that table are presented in the attached Table 2 and clearly shows that for all issues speculative grade performance was more than six and one-half times worse than investment grade and that those issues with no rating were not far behind. This information argues against the GSE points raised in support of OFHEO's original proposal to permit "BBB" haircuts for speculative grade and unrated counterparties.

The GSEs preferred to note in their comments that because railroad securities defaulted at such a horrendous rate that a better approximation might be to use only general industrial securities. However, even when considering only industrials, small issuers (not used in the GSE calculations) also tended to have worse performance. Pages 497 and 498 of the Hickman study clearly show that part of the problem for small issues may have been that these same issuers were also small in terms of asset size. (See attached Table 3 for excerpt from these pages.) Firms of smaller asset size experienced substantially higher default rates whether they were industrials or other types of operations. This observation is applicable to the treatment of unrated seller/servicers in the OFHEO RBC rule. With many unrated seller servicers holding few liquid assets beyond their servicing rights, Therefore, MICA believes it is inappropriate to grant "BBB" counterparty credit risk status to unrated counter-parties for safety and soundness reasons, as per our first comment letter.

The other major source of information regarding past performance of rated issuers is the Moody's historical corporate default series published annually for the past

several years. The latest report published in January 2000 covers default rates from 1920-1999. This series effectively 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 elapsed time. Consequently, it surpasses the Hickman study in terms of being able to assess worst-case scenarios by proper rating category.

Freddie Mac used the Moody's historical default series and based its discount proposal on selected portions of the Moody's database focusing on 10-year average default rates for 1970-1999. Freddie Mac asserts 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 recession did not demonstrate the same level of defaults. Consequently, Freddie Mac uses the selected Moody's data for average default rates (1970-1999) and triples the selected average default rate. Freddie Mac suggests that a multiple of three is sufficient based on a comparison of BLE default rates compared to its own long-term average loan performance. Then, to determine the appropriate maximum haircut Freddie Mac assumes a 50% recovery rate on the inflated average default ratio.

MICA does not believe that Freddie Mac's use of selected Moody's data is appropriate. Corporate default rates in the mid-1980s indeed were not as severe as they were in the Depression, but only because the conditions of the West South Central did not occur nationwide. The role of the stress test is to assume that the stress conditions apply nationwide. Under those circumstances we believe it fair to assume that corporate bond default rates would indeed rise to near record highs. MICA also believes that the Freddie Mac approach of "gross-up" corporate bond default rates in a stress scenario using the relationship between BLE mortgage default rates and any long term average mortgage default rate is illogical. The worst case scenarios which OFHEO used in its modeling are the ones that are most appropriate for the stress scenario. The GSEs have presented no evidence to justify a different approach.

## Recovery Rates

Both GSEs reference the Moody's reports as the primary source for their reasoning that any estimate of discount rates should be further adjusted by the assumption of some recovery rate. Indeed, Moody's says that it uses the trading price of defaulted instruments as a proxy for the present value of the ultimate recovery on a defaulted bond. However, they note that such valuation varies with the seniority of the lien as well as with the stated security of the debt and variations in recovery rates for defaulted bonds are correlated with macroeconomic conditions and the aggregate risk of default. Information published by Moody's suggests that the GSE-proposed recovery rate is an unrealistic assumption in a harsh economic environment. As recently as 1999, prices on all types of defaulted bonds fell below 40% of their face value. Yet it would be hard to characterize 1999 as a troubled economic time period. In 1981, at the start of the worst economic recession since the Depression, prices on defaulted senior/unsecured bonds fell to less than 10% of their face value (see exhibit 20 on page 19 of Moody's January 2000 Report).. This recent data demonstrates how inappropriate it would be for OFHEO to assume any recovery rate—much less a 30% or 50% rate as recommended by Freddie Mac.

The Freddie Mac proposed 30% to 50% recovery rate on seller/servicer servicing rights is also inappropriate. During the mid-to-late 1980s when many seller/servicers had poorly performing portfolios, GSEs seized the servicing rights of such companies prior to their eventual collapse. In these cases, GSEs were not only unable to sell the servicing rights to compensate themselves for the loss of recourse benefits, they had to pay new servicers additional fees to enable the new contractors to service the seized portfolios without incurring 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 could easily argue that with the 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 inventory of seized servicing portfolios.

Consequently, to assume any guaranteed recovery rate would seriously overstate the recovery potential for credit enhancements and thereby seriously understate the GSE's need for adequate capital. Moreover, while the GSEs have expressed concern with the complexity of the Model, the only prudent way to accommodate partial recoveries of defaulted credit enhancement benefits would require rather extensive additional modeling and retention of additional streams of information. As long as the bulk of credit enhancement benefits are provided from highly rated mortgage insurers, there is little additional benefit to be obtained from such additional modeling or assumptions regarding recovery rates.

MICA continues to support the level of haircuts for credit enhancement counterparties with different credit ratings and the spread between these haircuts as set forth in OFHEO's proposal, subject to the changes we suggested in our letter of March 10. Likewise, we believe neither GSE has presented a convincing reason for assuming a positive recovery rate under the stress scenario.

### **Unwanted Results**

In its earlier comments MICA highlighted the perverse results that are possible with the potential mishandling of mortgages in structured transactions. With regards to inadequate assumptions regarding default rates by rated entities, errors could lead not only to a false sense of security but to an erroneous application of risk-based pricing.

The largest variable in the determination of rating levels between issuers of corporate debt and, therefore, their probability of default is the level of capital held against the risks of the respective enterprises. In the realm of mortgage credit risk there is a consistent difference in the relative risk of default and the minimum capital required of AAA and AA-rated MI companies as compared to the same or lower rated non-mortgage insurance entities. If there is not an appropriate haircut differential which reflects the true ability of counterparties to absorb mortgage credit risk in a stress scenario, then the value of the difference in capital held by the higher rated MIs will be reduced. If either of the

GSE credit enhancement counterparty haircut proposals is adopted, the resulting RBC rule will cause a market shift in the share of credit enhancement towards lower rated entities. In the long run, the results of such a perverse incentive is not beneficial to either the consumer or the taxpayer. Therefore, an accurate portrayal of the ability of a credit enhancement counterparty to absorb mortgage credit risk in a stress scenario within the credit enhancement counterparty haircut scheme is essential to the safety and soundness of the GSEs.

**Table 2. Quadrennial Default Rates For High and Low Agency Ratings at Beginning of Periods**

		<b>Investment Grade</b>	<b>&lt;BBB</b>	<b>No Rating</b>	<b>Ratio &lt;BBB/Inv</b>	<b>Ratio No Rat/Inv</b>
<b>All Issues</b>						
	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
	1928-1939	10.57%	69.03%	56.63%	6.53	5.36
<b>Large Issues</b>						
	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
	1928-1939	9.93%	68.23%	57.18%	6.87	5.76
<b>Small Issues</b>						
	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
	1928-1939	14.30%	71.75%	57.93%	5.02	4.05
<b>Small/Large</b>						
	1928-1939	144.1%	105.2%	101.3%		

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

**Table 3. Default Rates Classified By Asset Size of Obligor at Beginning of Period**

		<b>Under \$5 Million</b>	<b>\$5-99 Million</b>	<b>\$100-199 Million</b>	<b>Over \$200 Million</b>	<b>Lacking Information</b>
<b>All Issues</b>						
	1928-1931	12.10%	6.80%	1.80%	0.80%	15.90%
	1932-1935	28.80%	19.20%	11.20%	15.90%	43.20%
Average	1928-1935	20.45%	13.00%	6.50%	8.35%	29.55%
<b>Industrials</b>						
	1928-1931	24.20%	12.80%	2.50%	0.00%	18.50%
	1932-1935	63.50%	33.50%	8.60%	1.80%	51.90%
Average	1928-1935	43.85%	23.15%	5.55%	0.90%	35.20%

W.B. Hickman , "Corporate Bond Quality and Investor Experience,"  
National Bureau of Economic Research, Princeton University Press(1958), p.497