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