

February 11, 2002

The Honorable Armando Falcon
Director
Office of Federal Housing Enterprise Oversight
1700 G Street N.W., 4th Floor
Washington, D.C. 20552

RE: Follow-Up Comments on Risk-Based Capital Rule

Dear Director Falcon:

The Mortgage Insurance Companies of America (MICA) respectfully requests that OFHEO consider this addition to the formal comments filed on January 17 in response to OFHEO's proposed revisions to the risk-based capital rule. We do so in light of recent developments, especially those with regard to Enron, as well as to errors in several of the comment letters filed with the Office on this proposal. This letter represents the agreed opinion of all MICA member firms.

Appropriate Haircuts for Counterparties With Ratings Below Those of the GSEs

We understand that OFHEO did not provide the opportunity for commenters to critique the comments of others, as was the case in NPR-2. However, MICA believes it is important to draw your attention to a fundamental problem inherent in the GSEs' comments that, if accepted by OFHEO, will result in the GSEs shifting credit risk to the weakest counterparties in exchange for receiving capital benefits under the risk-based capital (RBC) rule.

Fannie Mae and Freddie Mac should not be encouraged under the RBC rule to transfer credit risk to counterparties with ratings below that achieved by the GSEs themselves on a stand-alone basis. Currently, the GSEs stand-alone rating is, at best, a AA- and would no doubt be lower if their access funds via the implied government

guaranty were ignored. The RBC rule should not give the GSEs an incentive to shift risk to A, BBB or unrated counterparties which they will do if the capital regulations are too low, thereby allowing them to exploit their pricing advantages in the marketplace. The purpose of credit enhancement from the point of view of OFHEO is that the GSEs shift risk to a party with the financial ability to absorb that risk. The failure of the counterparty to deliver on its promise means that the GSEs will have to bear the risk they thought had been transferred. Moreover, this re-transfer of risk back to the GSE will most likely occur at a time of financial stress, when the GSEs will be financially strained to absorb yet another unexpected risk transfer.

In its January 17th comment letter, Fannie Mae seeks to minimize the inherent risk differential between counterparties rated AA and higher on the one hand and those rated A and lower on the other hand. It does this by suggesting OFHEO select default rates that minimize the difference between BBB and A rated counterparties and those rated AA and higher and then apply a recovery rate to all counterparties that is significantly higher than that achieved by BBB-rated entities. The result is, of course, to narrow the haircut that would apply to BBB and A-rated counterparties versus those rated AA- or higher.

Fannie Mae seeks to confuse the issue further by blurring the capital sources and premium income of private mortgage insurance with the income streams and collateral available to seller-servicers. Private mortgage insurers are rated AA- or higher for a reason. The AA or higher rating is driven by high levels of capital, premium income, reserves, proven risk management skills and geographic dispersion, as well as future premium streams. Mortgage insurers hold capital, and are regulated and rated, to assure that their capital is adequate to meet the stresses inherent in mortgage credit risk.

Unrated seller-servicers, on the other hand, face no stress tests and no capital tests. They

use their servicing income for many things, including covering their servicing expenses. Thus, at the point at which a GSE would seek to draw on credit risk mitigation, the seller-servicer would be under the same serious stress, incurring higher costs as a result of servicing a portfolio with higher delinquencies and foreclosures. Under such circumstances, the seller-servicer would be forced to decide between either honoring its GSE risk sharing agreement or meeting payroll, rent and other critical contractual obligations. If the GSEs were to seize the servicing rights under this stressful period, they would most likely realize little value, and possibly incur incremental costs to place the distressed servicing portfolio with another servicer. Further, since seller-servicers are often unrated and lightly capitalized, there is no independent oversight to ensure they will have capital available to meet their obligations. In sharp contrast, private mortgage insurers are highly rated, monoline institutions with dedicated capital, reserves, and strong regulatory supervision that ensures claims will be honored even under stressful conditions.

Risk of Unrated and Low-Rated Counterparties

The revelations as the Enron case continues highlight the importance of an extremely conservative approach to low-rated GSE counterparties as well as the hazards associated with risk transfers to unrated counterparties (e.g., off-balance sheet partnerships) with no rating agency or state insurance oversight. Low-rated companies can quickly descend from investment-grade to junk and then still farther down the risk spectrum. In Enron's case, the troubled firm was rated BBB+ even as its viability depended on completion of a complex merger. Standard & Poors down-rated Enron from BBB to non-investment grade only on November 28, 2001 after its merger was clearly impossible, but it was forced on December 3 to further down-grade the firm to a D rating. Clearly, external ratings - while an important source of information for the OFHEO rule - must be used with caution for lower-

rated and unrated institutions to avoid sudden drops in GSE capital as their counterparties credit situation rapidly deteriorates. As Enron makes clear, low-rated firms depend on market confidence to remain viable, and markets can turn with suddenness not anticipated in internal or ratings agency models.

Enron also points to the serious hazards associated with risk transfers to counterparties where conflicts of interest exist. This would include unrated or low-rated seller-servicers, who may have significant incentives to under-price credit enhancement in order to win other business advantages from the GSEs. Indeed, given their duopoly status, the GSEs may be able to force these high-risk firms to subsidize their credit enhancement to continue to sell mortgages into the secondary market through the agencies. The GSEs appear to anticipate this, given their comment letters supporting this inappropriate and low capital standard for seller-servicers. Under-priced credit enhancement as a result of such capital standards might boost GSE profits, but they will seriously expose taxpayers to risk due to the inability of such counterparties to handle their obligations under stress scenarios.

Risk of "Virtual" Ratings

In our initial comment, we expressed deep concern about the proposed upgrade of unrated seller-servicers that meet minimal back-up credit standards. As noted, this proposal exacerbates a serious flaw in the final rule, which would give unrated seller-servicers BBB-rated capital treatment, based on the incorrect view that qualifying to use a GSE's automated underwriting system is a form of financial regulation for these firms. These systems will likely give little protection during periods of severe economic stress, as even borrowers with high initial credit scores are not immune from job losses and other financial problems that occur during periods of economic recession or depression. Moreover, MICA believes that distorting the rating-based approach for unrated seller-servicers seriously undermines

the entire ratings-based approach of the overall capital rule, significantly reducing the market discipline OFHEO correctly seeks.

Indeed, the OFHEO rule could undermine the mortgage market as a whole, as well as raising serious concerns about the GSEs' credit risk transfers. If unrated seller-servicers are automatically rated BBB - and upgraded to AA after meeting very minimal conditions - it is unclear why any seller-servicer would seek an actual rating from a nationally recognized statistical ratings organization. Now, such institutions can win market benefits if they qualify for true high ratings, but the OFHEO rule will create a strong incentive for them to avoid external assessments of their credit-worthiness. Potentially low-rated ones will clearly avoid third-party ratings, since they will win the benefits of high ratings with no expenditure of capital or improvements to their prudential management.

Both GSEs have acknowledged in their annual reports that seller-servicers are the primary source of their counterparty risk. To bestow a virtual rating of BBB or AA on an unrated counterparty calls the meaningfulness of the entire RBC rule into question and distorts the incentives for all parties.

MICA believes that OFHEO should require strict adherence to its ratings-based approach for seller servicers, deleting the proposed upgrade for those with marginal back-up financing and revising the final rule to treat unrated firms with the strict risk-based capital appropriate for them. In any event, OFHEO should clearly state in the final rule that it intends to restrict the proposed capital model for unrated seller-servicers to multifamily seller-servicers.

Sincerely,

Suzanne C. Hutchinson

