March 8, 2000

Ms. Anne E. Dewey
General Counsel
Office of the General Counsel
Office of Federal Housing Enterprise Oversight
1700 G. Street, N.W., 4th Floor
Washington, DC 20552

Dear Ms. Dewey:

I am writing on behalf of United Guaranty Corporation (United Guaranty) and its subsidiaries to transmit the attached comment letter regarding the Office of Federal Housing Enterprise Oversight (OFHEO) Second Notice of Proposed Rulemaking (NPR2). I would like to emphasize that United Guaranty strongly supports the important role that the Government-Sponsored Enterprises (GSEs) play in creating home ownership opportunities for millions of Americans. Nothing that is stated here or in the attached comment letter should be interpreted to mean that we would wish in any way to alter or reduce that important role.

The following briefly summarizes the points that are of greatest concern to United Guaranty.

(1) United Guaranty believes that the majority of the OFHEO proposed regulations, including the stress-test model, represent a significant step in the right direction. NPR2 is an improvement over the current process, and it should be supported and enhanced. To the best of our knowledge, however, the actual capital levels proposed by NPR2 cannot be fully determined and examined outside of OFHEO. This leaves us unable to determine whether or not NPR2 provides for adequate overall levels of capital for the GSEs. As a result, we strongly urge OFHEO to make the model more open and subject to public scrutiny. We also urge that the final result be required levels of capital that are at least as conservative and prudent as those of other financial institutions that have implicit or explicit backing of the U.S. Government.

(2) United Guaranty worked with the Mortgage Insurance Companies of America (MICA) in developing its comment letter, and we support the MICA position. To avoid redundancy, the attached commentary does not reiterate many of the excellent MICA suggestions with regard to improving the stress-test model to better reflect the Benchmark Loss Estimates and to closing some NPR2 loopholes that may encourage GSE gaming of the rules. We strongly urge OFHEO to adopt the MICA suggestions or to develop equally effective rules to achieve the same objectives.

(3) United Guaranty does differ with other mortgage guaranty companies in the way NPR2 reflects rating agency expertise in the differential treatment of AAA-rated versus AA-rated credit enhancement haircuts. Our comment letter points out that rating differentials are well-documented by the rating agencies and widely accepted by the capital markets. The current haircuts proposed by NPR2 are consistent with these rating differentials.

(4) United Guaranty would like OFHEO to clarify the exclusive or preferred treatment of monoline mortgage guaranty insurance as a credit enhancement for high-LTV loans guaranteed or owned by the GSEs. We are not against GSE experimentation with alternatives, but until such alternatives have gained market acceptance and are proven to be secure, available, and price-stable for long periods of time, no capital credit should be allowed.

Our technical staff would be glad to meet with OFHEO at your convenience to discuss our views on any of these points.

Sincerely,

[signed: Charles M. Reid]

Charles M. Reid
President & CEO

OFHEO RISK-BASED CAPITAL REGULATION:

Conservative Regulation with Reproducible Models and Appropriate Recognition of Financial Strength Ratings

Response of United Guaranty Corporation (UGC), a wholly-owned subsidiary of the American International Group, Inc. (AIG) to the Office of Federal Housing Enterprise Oversight (OFHEO) Second Notice of Proposed Rulemaking (NPR2) on Risk-Based Capital Regulation

March 8, 2000

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Overview

United Guaranty Corporation and its subsidiaries provide mortgage guaranty insurance coverages to Fannie Mae and Freddie Mac. United Guaranty is a subsidiary of American International Group, Inc. (AIG), the leading U.S.-based international insurance organization and among the largest underwriters of commercial and industrial coverages in the United States. AIG member companies write property, casualty, marine, life and financial services insurance in approximately 130 countries and jurisdictions, and are engaged in a range of financial services businesses.

The risk-based capital regulations proposed by OFHEO in NPR2 are the first comprehensive set of regulations ever developed for two of the world's largest privately owned financial institutions, Fannie Mae and Freddie Mac. These government-sponsored enterprises (GSEs) provide an indispensable service to American home buyers, and they have become role models for many other countries across the globe. United Guaranty strongly supports the important role that the GSEs play in creating home ownership opportunities for millions of Americans.

Today Fannie Mae and Freddie Mac activities extend deeply into U.S. capital and financial markets. They are important for millions of Americans who own Fannie Mae or Freddie Mac securities through personal savings, mutual funds, pension plans and other investment vehicles. Both GSEs are intricately interwoven into the American economy, and we cannot afford for either to fail or to cease promoting new home ownership and investment opportunities.

The GSEs interact with other large financial service organizations like AIG in many ways. In some markets, the GSEs are vendors to AIG companies who invest in Fannie Mae and Freddie Mac securities, while in other markets, the GSEs purchase traditional insurance and financial products as customers of AIG companies. Fannie Mae and Freddie Mac are in some respects the largest two

beneficiaries of insurance issued by United Guaranty and its subsidiaries. The GSEs have also evolved to be highly respected competitors of United Guaranty in retaining or providing mortgage credit risk protection.

The expansion of the GSEs' activities in the 1990s is of prime interest to mortgage product and service providers like United Guaranty. This expansion is likely driven by growth-demanding stockholders, but it is somewhat confined by the GSEs' essentially monoline charters. Their charters have made it difficult to diversify either internationally or into non-mortgage businesses. By the late 1980s, Fannie Mae and Freddie Mac had already grown to dominate the conventional conforming secondary mortgage market. During the 1990s, they grew vertically and horizontally to touch in some fashion nearly every sector of mortgage lending.

This expansion has occurred in two areas: auxiliary mortgage services and risk taking. It is the latter that is of most interest to United Guaranty. Over the past decade, both Fannie Mae and Freddie Mac expanded into riskier markets, and they have taken higher risk positions in their traditional markets. They have become much more active in markets for so-called A-minus loans, high-risk alternative documentation programs and FHA and VA loans. They participate either by purchasing the mortgages themselves or by purchasing and holding mortgage-backed securities, sometimes their own issues. They have indirectly expanded beyond their Congressionally-mandated conforming loan limits by participating in structured combination loan programs in which a first and second mortgage are issued simultaneously. These programs allow the GSEs to purchase either the first or second loan up to the conforming limit, although the combined amount of the two loans (and the value of the home) can greatly exceed this limit.

The GSEs have also reduced their use of private mortgage insurance in favor of complex transactions that involve special non-refundable delivery fees, spread accounts that expose them to prepayment

risk, or recourse transactions that expose them to counterparty risk. They have experimented with securitizing segments of their risk exposure in order to increase their capital leverage.

Many of the these activities – including increasing their leverage – expose the GSEs to greater catastrophic risk while boosting short-term income. These practices increase earnings under good economic conditions, but they create the potential for significant losses in an economic downturn. The timing of NPR2 is fortuitous in this environment that has led Fannie Mae and Freddie Mac to push the risk envelope.

Need for Conservative Capital

As the result of these complex changes in GSE behavior, United Guaranty believes that the OFHEO guidelines should result in conservative capital adequacy regulations that are comparable to the regulations imposed upon private financial organizations. This is important, both to protect taxpayers and to promote fair and equal capital requirements for participants in all markets. The GSEs already enjoy a huge advantage over private companies in their ability to borrow funds at nearly the same rate as the U.S. Treasury. Allowing them to apply greater leverage than private companies is redundant, unnecessary, and not prudent.

Because the GSEs have the implied backing of the U.S. Government, they should operate in a very conservative manner. The last time an industry with implied or actual backing was allowed to operate without careful and conservative oversight, it cost the U.S. billions of dollars, and an entire industry virtually disappeared. We are not implying that another 1980s thrift crisis is in the making, but conservative capital rules and oversight are mandatory whenever there is government implicit or explicit backing.

Some observers have raised concerns that requiring Fannie Mae and Freddie Mac to increase capital would "raise the cost of home ownership." We think this effect is unlikely to be significant, because raising capital levels would not impact the GSEs' ability to continue to issue debt implicity backed by the U.S. Treasury.

Raising capital levels might increase the capital costs embedded in the Fannie Mae and Freddie Mac guarantee fees, but these are likely in the range of 3 to 6 basis points, and any percentage increase would be correspondingly smaller, perhaps less than a basis point. Competitive pressures and increased use of technology make it doubtful that any increase would be passed along to consumers. United Guaranty is skeptical that there would be any significant cost to homeowners as the result of a preventative prescription of conservative capital for both Fannie Mae and Freddie Mac.

Duplicating the NPR2 Model

We are concerned that the NPR2 model has proven impossible to duplicate (which is not quite in keeping with the spirit of the Congressional mandate to OFHEO). Its complexity and use of proprietary information has stumped the best private efforts to completely unravel it. As a result, the impenetrability of the OFHEO stress test model precludes anyone from determining whether the final GSE capital levels are comparable to other regulated financial institutions or reasonably adequate. It precludes determining whether or not GSE capital meets the Benchmark Loss Estimates set out in NPR1. United Guaranty asks that OFHEO try to find ways to make the model more open and accessible for interested parties to dissect and understand.

MICA Comment Letter

United Guaranty has participated with the Mortgage Insurance Companies of American (MICA) in developing a comment paper on behalf of that trade group. The MICA member companies have the most detailed mortgage credit historical data of any entity, inclusive of Fannie Mae and Freddie Mac, particularly for high-LTV loans (which account for the majority of the credit risk in the GSE portfolios of loans and MBS guarantees). Using this expertise, MICA appears to have duplicated some sections of the OFHEO stress test model. As a result, the MICA comment letter contains creative improvements to the OFHEO approach, and it presents suggestions that reduce the opportunity for the GSEs to game the regulation. United Guaranty strongly supports the model improvements and suggestions contained in the MICA comment letter.

Counterparty Credit Ratings

The current draft of NPR2 provides for varying “haircuts” for counterparty credit enhancements based on the credit rating of the counterparty. We support this OFHEO approach to assign varying haircuts that differentiate among the major rating agency categories, such as A, AA and AAA. They also are consistent with the way the capital markets treat differently rated tranches of mortgage-backed securities and counterparty risk. These differentials are consistent with how the rating agencies themselves evaluate United Guaranty and its parent, AIG. Unfortunately, the MICA comment letter opposes this treatment. This is the only material point upon which United Guaranty disagrees with MICA.

The Standard & Poor’s rating methodology for mortgage guaranty insurers supports a differential treatment of AAA and AA rated companies. A necessary condition of a AAA rating is that the MI company be able to pass the S&P stress test, which is a simulation using actual loss development over

a 10-year period of the South Central region (Texas, Oklahoma, Arkansas and Louisiana). This simulation is similar to the OFHEO stress test model. In the model, S&P compares the company's sources of funds (initial capital, premium income and investment income) with the company's uses of funds (expenses, claims payments). If the company has sufficient sources to pay 100% of the uses, the company passes one hurdle necessary for a "AAA" rating. In order to be considered for a "AA" rating, a company can have sources that cover as little as 75% of the uses of funds (a company close to the 75% level might receive an "AA-" rating). On average, using this formula, the AA-rated companies should have about seven-eighths (87.5%) of the stress scenario funds. This figure can be found in S&P literature about its rating of MI companies.[1] This differential is similar to the differential implied by the NPR2 proposed haircuts [80%(AA) divided by 90% (AAA) = 89%].

S&P uses a similar approach to value reinsurance credit in the insurance industry. Reinsurance is the insurance risk equivalent of a credit risk enhancement. A reinsurer is a company that agrees to take insurance risk away from a primary insurer and, in a sense, acts as a credit enhancer to insurance risks held by the primary insurer. Standard & Poor's allows a higher-rated reinsurer to reinsure a lower-rated primary insurer with no haircut. However, if a AA-rated company reinsures a AAA-rated insurer, then the AAA insurer gets credit for only 70% of the value of the reinsurance (equivalent to a 30% haircut). If the AA insurer is downgraded to A, then the AAA insurer would only get 49% credit (a 51% haircut) for the value of its reinsurance. Again, these haircuts are similar to those proposed by OFHEO.

S&P and the other rating agencies also impose other more conservative factors on AAA-rated companies in other aspects of their financial reviews. In a July 18, 1997 release titled "*GSE Pool Insurance Capital Charges for Mortgage Insurers,"* Standard & Poor's specifically calculates the

[1] The seven-eighths figure appears in Appendix 1 of *Changing Times: The Outlook for U.S. Residential Mortgage Insurance 1997-2000,* Standard & Poor's, a Division of the McGraw Hill Companies, 1997.

capital charge at 100% of the present value of the worst-case loss scenario for AAA-rated MIs and 87.5% for AA-rated MIs.

The rating agency distinctions also apply in a conceptual framework. In the October 1997 "*U.S. Insurance Statistical Handbook,"* Moody's Investors Service (Moody's) describes its insurer financial strength ratings for insurers. Moody's describes Aaa-rated insurance companies as those that offer "exceptional financial security." Any changes in the financial strength of Aaa companies "are most unlikely to impair their fundamentally strong position." In contrast, Aa-rated insurance companies offer "excellent financial security," and "they are rated lower because long-term risks appear somewhat larger."

The Moody's comments are particularly relevant if ratings migration risk is considered. Ratings migration risk is the likelihood of a ratings downgrade after the initial credit enhancement is obtained. In the case of credit enhancements for 30-year mortgages with significant loss potential over the first 12 years, ratings migration risk becomes a significant issue. The 1997 Moody's commentary in effect points out that there is a higher probability that an unforeseen future event could result in a double-A rated company falling to single-A or lower. A triple-A company would have to fall two ratings categories, clearly a much more remote possibility. This risk carries a higher probability of occurring than does insolvency, and it has the potential to significantly affect GSE capital as it is applied to the haircuts for counterparty credit enhancements in NPR2. If OFHEO follows another MICA recommendation to reduce the haircuts for AA-and-higher-rated mortgage guaranty insurance counterparties, then the ratings migration risk becomes even greater.

The capital markets recognize the ratings migration risk and rating differentials of mortgage guaranty insurers explicitly. United Guaranty has been an active insurer of mortgage pool insurance on jumbo securities throughout the 1990s. Investors have shown a clear preference for AAA-rated insurance protection over AA-rated protection.

From time to time, AA-rated MI companies have made the argument that differentiating between AAA and AA from a policy standpoint may raise the cost of mortgage insurance to the consumer. We disagree. The AAA-rated insurer, by virtue of having passed a higher stress test requirement, may have a higher cost of capital and may charge slightly more for its enhancement. However, allowing the GSE to take a greater credit for its AAA rating simply puts the value of this AAA credit enhancement on an equal footing with the lesser-value-but-less-expensive AA credit enhancement. In this environment, AA-rated MIs would not be compelled to obtain more expensive AAA ratings, as the GSE may value some combination of both types of coverage, depending on its risk tolerance and exposure. It might encourage some AA+ companies to obtain, relatively cheaply, the additional reinsurance or capital infusion necessary to upgrade to a AAA rating and thus provide a better credit enhancement to the GSEs, but this is likely to occur only if they can do so profitably within the current cost structure. Again, in no case is there likely to be any incentive to raise MI costs by either AA or AAA companies.

Important Role of Mortgage Guaranty Insurers

United Guaranty is concerned that, in allowing for alternative credit enhancements to be favored above those of monoline mortgage guaranty insurers, NPR2 runs a significant risk of setting back mortgage credit enhancement regulation some 75 years to the Great Depression. The modern day MI industry developed along an innovative set of sound state regulations first passed in Wisconsin in the late 1950s. These regulations established a number of stringent requirements that resulted in a financially conservative mortgage guaranty industry, which pioneered low-down-payment home ownership throughout the 1960s and 1970s and survived the century's second-worst real estate collapse in the Oil Patch in the 1980s. These regulations were designed to avoid a repeat of the collapse of mortgage insurers and their affiliates that occurred during the Great Depression. These regulations include the monoline requirements, contingency reserves, dividend restrictions, and

extremely conservative accounting and investment policies. No other credit enhancement industry is subject to anywhere near this level of regulation and conservatism.

In allowing the return of mortgage insurance credit enhancements in 1959, the states recognized that mortgage credit risk is so volatile that only a monoline company, dedicated to this risk and operating under strict state regulations, could hope to insure this risk in a sustained and reliable manner over the long term. United Guaranty believes that OFHEO would be most shortsighted to compromise this successful state-regulated private enterprise solution.

The NPR2 discussion of derivatives appears to apply only to interest-rate derivatives, which have developed into a robust and sophisticated, although occasionally volatile, financial market. We hope that OFHEO will clarify that its haircuts and other regulations apply only to interest rate derivatives, and that credit derivatives cannot be used for credit enhancements until that market develops further and more specific regulations and protections.

In summary, United Guaranty supports the exclusive use of monoline mortgage guaranty insurance as a credit enhancement for high-LTV loans. We are doubtful that a dedicated, stable and reliable capital market for high-LTV mortgage credit risk will emerge in the timeframe contemplated for NPR2 to be implemented. We are also doubtful that other financial institutions wishing to provide mortgage credit enhancements from time to time can provide anywhere near the stability and availability of private mortgage guaranty insurance over the long run. Any experimentation by the GSEs into untested alternatives should be conducted without any capital credit until it can be demonstrated to be a secure, long-term alternative.