June 23, 2000

Office Of Federal Housing Enterprise Oversight
Attn: Ms. Jeannine T. Schroeder
Senior Management Analyst
1700 G Street NW
Washington, DC 20552

Dear Ms. Schroeder:

Thank you for giving GE an opportunity to present our comments, analysis and recommendations to OFHEO on Wednesday, June 21. We have worked very hard during this past year studying the proposed rulemaking and replicating the model to ensure that our understanding of the RBC model would be accurate and complete. We believe that our comments and recommendations reflect an analytical approach to risk-based capital. Although you have many comments to review and consider, we hope that our diligence, analytical approach and unique perspectives as both a mortgage insurer and originator, securitizer and servicer of residential mortgage loans provide OFHEO with a well rounded view on the risks inherent in residential mortgage finance.

Productive as our meeting was, as I was flying back to Raleigh I was frustrated that I was unable to clearly communicate our views regarding the haircut treatment for derivative counterparties. Please indulge me as I try to put in writing what I feel I did not effectively communicate in our meeting.

As we see it, while there is (and should be) a difference between “cash on hand” and an unfulfilled promise to perform (counterparty credit risk), there should not be any haircut difference between counterparties based on transaction structure. Instead of giving a lower general haircut to derivative counterparties, we have unbundled the collateralized and non-collateralized portions of the derivative contract. Any cash or Treasury collateral that the GSE’s have a perfected security interest in at the start of the stress test (to support any mark-to-market obligation or otherwise) should receive a 2% haircut. Any other cash flows that are modeled as receipts (cash inflows) during the ten year stress test which are due from any counterparty should be haircut based on the rating of such counterparty. This treatment would apply to any form of interest rate or credit support that the GSEs enter into (whether documented as a derivative contract or other contractual agreement). Hopefully the following example will help illustrate our proposal.

Assumptions

Derivative counterparty rating: AA
Notional balance of derivative contract: $1 billion
Term: 12 years
Cash collateral securing mark-to-market obligation at beginning of stress test: $175,000
Cash-flows receipts due the GSE under the RBC model total $300,000, as follows:

Year 1:	$ 50,000
Year 2:	$100,000
Year 3:	$ 75,000
Year 4:	$ 50,000
Year 5:	$ 25,000
Years 6 – 10:	Zero

OFHEO would haircut all $300,000, using the proposed 4% "AA" haircut for derivative counterparties. We would haircut the first $175,000 of cash flows at 2% (since this cash was already held at the start of the stress test). The remaining $125,000 of cash flow anticipated, but not yet collected, would be haircut at 20%, the haircut proposed by OFHEO for "AA" non-derivative counterparties.

As we understand your approach, the lower derivative haircut is merited because: (1) $175,000 out of the $300,000 has already been collected, and (2) the additional $125,000 due from the derivative counterparty would be paid earlier than the modeled cash flows due to mark-to-market requirements under the derivative contract. If our understanding is correct, the final rule should state so clearly and provide any counterparty (derivative or otherwise) to structure its contractual obligations to receive equal treatment.

I hope this example clarifies our position. The GSEs should be allowed to structure their contracts however they wish to minimize counterparty credit risk, but the risk of counterparty non-performance is identical whether the transaction is structured as a derivative contract, insurance policy or lender recourse arrangement. Future uncollateralized cash flows should not receive a more favorable haircut treatment based on a counterparty's prior ability to fund mark-to-market obligations.

Our unbundled approach has the additional advantage of being applied uniformly, which will reduce the incentives (and, one hopes, examination expense and effort) to use interest rate derivatives to cross-subsidize credit risk. The amount of interest rate derivatives used by the GSEs to manage interest rate risk in their large and still-expanding portfolios is a serious concern by itself. If cross subsidization is allowed, the GSEs could purchase haircut-advantaged interest rate protection to lower their capital requirements instead of purchasing more prudent credit risk protection.

Again, thank you for hosting the meeting on Wednesday and letting us discuss our analysis and recommendations. We look forward to working closely with you during the remainder of the year.

Sincerely,

James C. Zollo
Managing Director

JCZ:mab

cc: Pat Lawler
David Pearl