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January 16, 2002

Mr. Alfred Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
Fourth Floor, 1700 G. Street, N.W.
Washington, DC 20552

Dear Mr. Pollard:

I am writing on behalf of United Guaranty Corporation (United Guaranty) regarding the Office of Federal Housing Enterprise Oversight (OFHEO) Proposed Regulation published in the *Federal Register* on December 18, 2001.

As United Guaranty has stated in previous comment letters, we strongly support the important role that the government-sponsored enterprises (GSEs) play in creating home ownership opportunities for Americans. We also recognize the hard work put into the GSE capital rule by the OFHEO staff and their willingness to meet and participate in conference calls with representatives from United Guaranty and its trade organization, Mortgage Insurance Companies of America (MICA) on numerous occasions.

Even so, the attached comments reveal significant concerns about many aspects of the December 18 proposal.

We appreciate your careful review of our arguments, and encourage you to contact us if you have questions or require clarification of any of the statements contained herein.

Sincerely,

William V. Nutt, Jr.
President and CEO

OFHEO RISK-BASED CAPITAL REGULATION

Comments on the December 18, 2001 Proposed Changes to OFHEO's Final Risk-Based Capital Rule Published September 13, 2001

Response of United Guaranty Corporation (United Guaranty), a wholly-owned subsidiary of American International Group, Inc.

January 16, 2002

Contents

United Guaranty has a number of concerns with OFHEO's proposed changes, published December 18, 2001, to the Final Risk-Based Capital Rule, which was published in September 2001 after nine years of development. These concerns fall into two areas: the process by which rules have been revised and the revisions themselves.

To illustrate some of the points that follow, we extracted and derived numbers from the public financial statements of Fannie Mae, the larger GSE. The limited time allowed by the 30-day comment period and the complexity of both GSEs' financial statements did not permit us the luxury of extracting and summarizing the data for both. Our concerns apply to both GSEs and we have not the slightest intent to single out Fannie Mae in these comments.

I. United Guaranty Recommendations

The following recommendations are made with respect to the comments made throughout this comment letter:

1. United Guaranty requests that OFHEO provide the public with full, supported working models with appropriate GSE starting point data.
2. United Guaranty requests an extension of the comment period until 120 days after the time OFHEO makes a working model and the necessary data available to the public.
3. We request that in the meantime, OFHEO publicly report its estimates of the required capital under the September 13, 2001 final rule and the December 18, 2001 proposal.
4. OFHEO must publicly assess the costs and benefits of all future rules, whether or not they "better reflect the risks faced by the Enterprises" and whether or not OFHEO determines them to be economically significant.
5. OFHEO should reinstate the five-year phase-in for counterparty haircuts as contained in the September 13, 2001 final rule or at most a six-year or seven-year phase-in.
6. OFHEO should clarify that the haircuts for derivatives counterparties apply only to interest rate derivatives and that credit derivatives will be treated no better than non-derivatives counterparties until OFHEO can develop specific rules for credit derivatives and subject these new rules to public comment.
7. OFHEO should reinstate the haircuts contained in the September 13, 2001 final rule for non-derivative counterparties.
8. At the earliest possible opportunity, OFHEO must revisit its unjustified prejudice against insurers and consider eliminating any haircut differential between derivatives counterparties and non-derivatives counterparties. Actual collateral posted could be treated as cash (or the appropriate investment security), whether it is posted by a derivatives counterparty or by an insurer.
9. OFHEO needs to set derivatives collateralization standards regarding the amount and the nature of the collateral.
10. OFHEO should not allow unrated seller-servicers posting as little as 1% collateral to be treated as if they were double-A-rated.
11. The model needs to treat the first mortgage in an 80-10-10 structured mortgage the same way as it would treat a 90% LTV mortgage. Allowing the model to reflect the

higher fees the GSEs impose (for the higher risk), but **not** modeling the accompanying risk will understate stress test capital.

12. The model defined by the final rule does not fully account for the risk presented by very-high-LTV mortgages. We recommend separate risk categories in the model for very-high-LTV mortgages.
13. Although we do not want to suggest specifically how OFHEO should treat spread accounts, we recommend that they be valued in the same way OFHEO values Guarantee Fee revenue, rather than OFHEO's "60-months same as cash" method.

OFHEO Disclosures

In addition to the reforms listed above, the comments and actions taken by OFHEO with its December 18 revisions raise serious questions about how OFHEO will to manage the public comment process, consistent with the intent of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (hereafter referred to as the "1992 Act"). We would like responses from OFHEO on the following questions:

1. In light of the systemic risk presented by recent failures such as Long-Term Capital Management (LTCM) in 1998, what standards will OFHEO apply to determine whether or not a rule is "economically significant" ?
2. Since we would hope that **all** future rules "will better reflect the risks faced by the Enterprises", under what conditions, if any, does OFHEO intend to assess the costs and benefits of new rules and provide that information to the public?
3. Why has OFHEO changed its practice (from that of NPR2) with regard to disclosing the impact of rule changes on required GSE capital levels?
4. Why does OFHEO allow the GSEs to produce alternative, potentially misleading estimates of their required capital to the public when OFHEO does not release its own estimates?
5. How does OFHEO justify meeting the 1992 Act disclosure requirements and its own announced "transparency" goals (see pages 3 and 4 of this document), without giving the public the necessary models and data to verify and measure the impact of proposed rule changes on GSE capital?
6. A clarification from OFHEO about what it means by the "inappropriate business incentives" statement is clearly warranted.
7. OFHEO needs to publish and discuss the **effective haircuts** in its model and the implied leverage ratios by counterparty ratings category as defined in this comment paper.
8. OFHEO needs answer the question: ***If triple-A-rated derivative counterparties are not required to collateralize, then why should not triple-A-rated non-derivative counterparties have the same haircuts?***

II. Background

Why the Final Rule Is So Critical

The sheer size of the GSEs dwarfs any other regulated financial institution in the United States. The combined debt of the GSEs, over $1.2 trillion, exceeds that of any other private U.S. corporation and most nations, and is exceeded by the debt of the U.S. Treasury only by a small multiple. Of course the total mortgage activities of the GSEs cannot be discerned

solely by looking at their debt. Selected Fannie Mae financial data from September 30, 2001 shows a total "book of business" of $1.5 trillion in mortgages, of which $817 billion is composed of mortgage-backed securities (MBSs) held by investors other than Fannie Mae's portfolio and the remaining $687 billion is held as invested assets. Perhaps already in excess of $2.25 trillion, the combined size of the loan guarantees, securities, and assets for which the GSEs are exposed to mortgage risk is staggering.

We cannot over-emphasize how important the OFHEO final rules will be to protect the U.S. and world economy. No other regulator on this planet faces such a concentration of risk and debt under the control of so few individuals, namely the boards of directors of the GSEs. Dynamic, conservative, transparent[1] and objective regulatory oversight is absolutely necessary for the kind of global systemic risk presented by the GSEs.

III. Comments About the Publication Process

OFHEO Statements About Regulatory Impact

OHEO states in its December 18 proposal that "the impact of the refinement is not economically significant." Later, OFHEO makes the statement that "OFHEO is not required to provide the type of regulatory analysis that is required for an economically significant rule." We would like clarification of how OFHEO determined that the refinement is not economically significant and what level of change to the GSEs' capital it considers to be economically significant. We estimate (and without access to a working capital model, this is a very rough estimate) that the change to the counterparty haircut provisions alone might exceed $2 billion dollars of potential capital reduction for the GSEs. Does OFHEO not consider $2 billion in capital significant?

Furthermore, if one provision of the proposed changes reduced GSE capital by $2 billion and another increased GSE capital by $2 billion, would OFHEO consider the impact, in total, to be "not economically significant?" If so, we dispute this interpretation.

The failure of the hedge fund Long-Term Capital Management (LTCM) in 1998 was precipitated by accumulated derivatives losses in the range of $2-3 billion. This failure prompted the intervention of the Federal Reserve and follow-up investigations by Treasury, the SEC, the GAO, the IMF and a special working group set up by President Clinton. Surely, capital fluctuations in the range of $2 billion are "economically significant."

OFHEO also states in its December 18 proposal that "rather than trying to assess the costs and benefits of every change to the stress test, OFHEO looks to whether or not the changes it is proposing make the Rule better reflect the risks faced by the Enterprises . . ." We cannot imagine that OFHEO would propose a change to the final rules which it believes to ***worsen*** the risks faced by the Enterprises; therefore, are we to conclude that OFHEO does not intend to assess the costs and benefits of ***any*** future changes to the Rules? Under what conditions would OFHEO consider a change to be worthy of assessing the costs and benefits?

[1] As implied in OFHEO's strategic plan, issued August 30, 2000, page 11 (see also the quote on page 4 of this document).

Lack of Public Information on Effects of Capital Rules
OFHEO has released no information regarding the level of capital required by the "final" rule published on September 13, nor has it released any information regarding the December 18 proposed changes. In fact, OFHEO has since stated that it does not intend to publish how the Enterprises will fare under the December 18, 2001 risk-based capital revision until June 2002. In a January 2002 conference call, OFHEO further announced that it does not intend to publish the estimated effect of the December revision on GSE capital.

In the second Notice of Proposed Rulemaking (NPR2) published on April 13, 1999, OFHEO did estimate capital requirements under the rule (NPR2) for two dates – September 30,1996 and June 30, 1997. However, it has not done so in either the final rule or the December 18 proposed revision. What is the reason for the change in policy? In order to state that they are not economically significant, OFHEO must have estimates of the changes to GSE required capital.

In conference calls since December 18, OFHEO has said that other federal bank regulators typically do not publish the overall effects of capital rules on the banking industry. In fact, under their own regulatory requirements, including SEC rules, banks generally make these disclosures themselves. The GSEs are exempt from other regulatory requirements including most SEC rules, and have made no such disclosures using the strict OFHEO model, and – clearly – OFHEO is not filling the void.

On August 30, 2000, OFHEO released a draft of its FY 2000–2005 Strategic Plan. On pages 11 and 12 of that plan, OFHEO states the following (emphasis added by the commentator):

> A key OFHEO strategy is the effective public presentation of safety and soundness standards to permit both ***transparency*** of its regulations and a strong foundation for compliance by the Enterprises. . . . Enhancing the public's understanding of the nation's housing finance system, including the roles and activities of the Enterprises and OFHEO, contributes directly to the strength and vitality of that system. The public—borrowers, investors, market participants, policymakers, and other stakeholders—will make better decisions about the allocation of their resources if they are well informed. OFHEO, with its expertise in housing finance, is uniquely positioned to provide the public with information and analysis that will lead to more informed decision-making by the public. . . . OFHEO will also make its research and analysis available to the public to enhance the public understanding of the nation's housing finance system.

We believe that OFHEO should revisit its strategic plan as regards disclosure of its December 18, 2001 revisions of the Final Rules for Risk-Based Capital.

We respectfully request that the required capital under the September 13, 2001 final rule and the December 18, 2001 proposal be made public immediately.

Fannie Mae Voluntary Initiative
As outlined in Fannie Mae's March 26, 2001 press release, it publishes a voluntary initiative each quarter to "give an indication of the amount by which its total capital exceeds or falls short of the calculated risk-based requirement." Fannie states that it "constructed an interim

implementation of the risk-based capital test using as its basis OFHEO's notice of Proposed Rulemaking 2 (NPR2), modified to reflect subsequent changes implemented or suggested both by OFHEO and the company. . . . In constructing its interim stress test, Fannie Mae has incorporated OFHEO's NPR2 changes along with changes recommended in the company's March 10, 2000 comment letter and various other refinements enumerated on the company's Web site." For third quarter 2001, Fannie indicates that its capital exceeds the requirement of its model by more than 30%.

It is extremely unfortunate that OFHEO does not release information to the public about GSE compliance, but allows the GSEs to publish their own versions without challenging them. Fannie admits that OFHEO has not approved its internal numbers. OFHEO's failure to stop the publication of alternative models or views by the GSEs is inappropriate.

We think Fannie Mae appreciates the public's need to know how it measures up against the rules. It is time OFHEO did likewise.

Congressional Intent in the 1992 Act – Providing the Model to the Public

The lack of public information is exacerbated by a continuing neglect of the Congressional intent as described in The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the legislation that created OFHEO. ***Section 1361(f) of the 1992 Act specifically requires that the director of OFHEO make copies of its capital models available to the public for a reasonable charge. Nine years later, no such working model has been made available.***

What *has* been released thus far is unsupported source code, hardly a "model" that can be used by the public. The source code requires extensive software purchases and probably an investment of several hundred thousand dollars to install. Furthermore, OFHEO staff have not provided a validated working model to ensure that members of the public have a model that duplicates the results used by OFHEO. We believe OFHEO has provided a validated working model to both GSEs. Finally, OFHEO has ruled that the GSE starting data – needed to measure the impact of the model on the GSEs at any point in time – is proprietary and not available to the public. Consequently, no member of the public will ever be able to measure the impact of any aspect of the model on an actual operating GSE or even the GSEs on a combined basis.

If the public is unable to assess the OFHEO rule changes on GSE capital, is this not inconsistent with the 1992 Act? The public has been left with a non-working, unsupported and sterile model – a technical duplicate of the OFHEO model computer source code, but no data to run it for the intended purpose.

A sterile public model is of little use for public comment and certainly no match for the public comments that the GSEs will be able to make with full, supported working models.

Request for an Extension

United Guaranty respectfully requests an extension of the comment period until 120 days after the time OFHEO makes available to the public the data and model with adequate GSE starting point data. This will permit adequate time to enable us to present our views in a manner that is as comprehensive and as helpful to OFHEO as possible. This wording

quotes OFHEO itself, which granted an extension of the comment period to the GSEs for the recently proposed Corporate Governance regulation:

> OFHEO has received requests from the Enterprises for an extension of the current deadline of November 13, 2001, for comments to permit adequate time to enable them to present their respective views in a manner that is as comprehensive and as helpful to OFHEO as possible. In recognition of the importance of obtaining fully developed and constructive comments as to the implication of this proposed rulemaking, OFHEO is extending the comment period for the Corporate Governance proposed regulation from November 13, 2001, to December 13, 2001. This is to ensure that all interested parties have ample opportunity to participate in the rulemaking process by providing meaningful comment in the development of the corporate governance regulation." (66 *Federal Register* 56619, November 9, 2001)

As should be evident, access to a working model is necessary for us to develop more meaningful comments. Many times in this comment paper, we are forced to use rough approximations, due to OFHEO's failure to provide us with a working model. It would be a shame if the GSEs are able to refute our arguments with full access to working models from which they can extract just the partial information that supports their views.

The proposed 30-day comment period running from December 18 to January 17 – spanning two major holidays – is ludicrous for changes of the magnitude that OFHEO is proposing. It is effectively a 15-day comment period. The changes are to sections of the rules that the GSEs – in published material relating to NPR2 – indicated could amount to billions of dollars in capital (OFHEO has provided no numbers to refute this assertion). So why make changes of such magnitude with the minimum required comment period? Why now, after nine years of delay?

Technical Corrections, Operational Issues, and Time Urgency

In the December 18 proposal, OFHEO notes that it "committed to act expeditiously to remedy any technical and operational issues that arise during the one-year implementation period following promulgation." [page 65147] Strangely, the implementation period does not appear to have been initiated. The model does not appear to be operational; at least nothing about its operation has been disclosed to the public or mentioned in the December 18 proposal. Nor are the changes merely technical – many of them affect major provisions of the September 13, 2001 final rule and probably change required GSE capital levels by hundreds of millions – if not billions – of dollars.

We do believe OFHEO should indeed ***act expeditiously***. Nine years – going on ten – from the 1992 Act is too long. OFHEO needs to ***act expeditiously*** to implement the final rule published September 13, 2001, which was developed after a lengthy comment period and thorough review process and which OFHEO itself, before and after publication, refers to as its "final rule." OFHEO needs to proceed with providing a working model of these final rules and provide the public with an estimate of the capital impact on the GSEs.

IV. Comments About the December 18 Proposal

The aspects of the final rule that are of greatest concern to our company are:

Non-derivative Counterparty Haircuts
United Guaranty supports the final rule haircuts for non-derivative counterparties contained in the September 13, 2001 release. We believe this reasonable recognition of triple-A credit quality is a necessary foundation for GSE safety and soundness.

The September 13, 2001 final rules refer to extensive research by OFHEO for data that would indicate appropriate haircut differentials by counterparty ratings. As quoted on *Federal Register*, page 47804, "In response to comments that those counterparty haircuts were too severe, OFHEO conducted extensive analysis of the historical data, including some updated rating agency data and studies submitted by commenters." On page 47775, OFHEO states, "haircuts included in the final rule reflect consideration of the relationship between cumulative default rates in normal and stressful times, the ameliorating effect of phasing in cumulative default levels from 1920 through 1997. In the course of evaluating the recommendations for lower haircuts [versus the NPR2 version printed in 2000] OFHEO reviewed Moody's 2000 bond study, as well as the Hickman study."

OFHEO goes on to say:

> . . . With respect to the relationships among cumulative default rates for credits in different rating categories, the Moody's data for 1920–1999, as reflected in the table, show cumulative defaults roughly tripling between the triple-A and double-A categories….Haircuts included in the final rule reflect consideration of the relationship between cumulative default rates in normal and stressful times, the ameliorating effect of phasing in haircuts over time, mixed commenter opinion with respect to recoveries, the potential for insurance premiums or servicing fees to partially offset losses on mortgage credit enhancements, as well as the relationships among cumulative default rates for credits in different rating categories. OFHEO determined that the haircuts proposed in NPR2 should be reduced and phased in more quickly. [page 47775]

This was very logical, so what did OFHEO suggest that caused it to make the triple-A versus double-A haircut changes in the December 18 proposal, just three months later? Basically, OFHEO relied upon unpublished data from Moody's Investors Service for just three cohort years – 1929, 1930, and 1931. These data have never before been made available to the public and are only now available at a cost of $5,000 per requestor. We demand that OFHEO and Moody's disclose who commissioned this study at Moody's. OFHEO should provide a better explanation of why it would disregard more than a year of extensive research and long-term historical evidence for just 3 years of Great Depression Era data. The data are 70 years old and on an isolated basis, and could not possibly be an adequate foundation for determining anything as important as the triple-A/double-A ratings differentials. In any case, we have not had time during the comment period to obtain and evaluate these additional data.

It is very clear from the recent experience of Enron, LTCM, Metalgesellschaft, Barings PLC and Drexel Burnham Lambert, that it does not take a Great Depression Era to stress highly

leveraged financial or trading institutions. Why would OFHEO amend its final rules based on unpublished data from just three cohort years of the last 70?

Why is OFHEO Concerned About Business Incentives?
Since most derivative counterparties and mortgage insurance (MI) companies are triple-A or double-A rated, the impact of the haircut differentials on GSE required capital will be significant. OFHEO states in the December 18 proposal, that "an excessive differential between these ratings in the stress test could create ***inappropriate business incentives*** for the Enterprises." We believe this point should be clarified publicly by OFHEO.

We hardly see how the moderate triple-A versus double-A haircut differentials contained in the September 13 final rule creates an "inappropriate business incentive." OFHEO has provided no clarification of what it meant by this term. Could OFHEO possibly have been thinking that the incentive for a GSE to favor a higher-credit-quality counterparty would be inappropriate?

Today, for Fannie Mae- and Freddie Mac-purchased loans, the interest rate paid by the borrower will be the same whether or not the MI is rated triple-A or double-A. The security created by the GSE will pay the same interest to investors whether or not the MI on the high LTV loans is triple-A or double-A. The GSEs pay loan sellers the same interest rate and charge the same guarantee fees whether or not the MI they obtain is triple-A or double-A.

These current GSE market practices are completely different from what happens in private MBS markets. A triple-A-rated security will trade at a lower interest rate than a double-A-rated security. A securitizer using triple-A-rated credit enhancements can provide a slightly lower interest rate to loan aggregators who in turn pass that back to the loan originators in lower interest rates or higher servicing spreads. Does OFHEO think that this kind of business incentive, which is routine in private, non-government-sponsored enterprise, is ***inappropriate?*** We do not understand why OFHEO would think that preservation of the current GSE market practices result in appropriate business incentives versus changing them.

We disagree that OFHEO has established that the September 13 final rule creates an "excessive differential." The only data to support this are from three cohort years versus very substantial long-term data to the contrary.

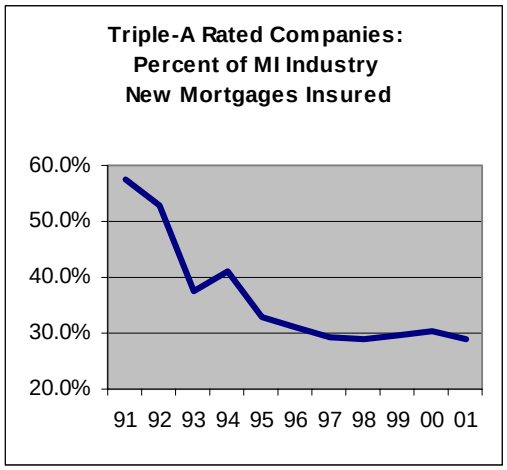
OFHEO Should Focus on Safety and Soundness
The OFHEO capital rules will inevitably cause the GSEs to more highly value the credit enhancements from counterparties achieving one rating classification versus another relative to pre-OFHEO practices. Depending on the size of the change and the strategies of the GSEs and the counterparties being rated, this may or may not create some "business incentives" for the GSEs to favor some counterparties over others as compared to the patterns that may previously have existed.

OFHEO needs to concentrate on the safety and soundness of the GSEs and not concern itself with the natural evolution of markets in response to GSE strategies. We do object when OFHEO capital rules and the government subsidies give the GSEs unfair competitive advantages over competing private businesses in products and services not contemplated by their charters, but we are fairly sure this is not what OFHEO had in mind on this issue.

A clarification from OFHEO about what it meant by the "inappropriate business incentives" statement is clearly warranted.

The actual mix of triple-A MI companies insuring the GSEs during the 1990s declined dramatically, primarily because the GSEs do not value the mortgage insurance provided by triple-A-rated insurers any differently than that provided by double-A-rated insurers.

Figure 1: Mortgage Insurance Market Share of Triple-A Rated Companies, 1991–2001



Source: MICA

In 1991, there were three triple-A-rated MI companies with a new business market share of 57% of the total industry. By 2000, the triple-A-rated share had declined to below 30%. One of the MI companies rated triple-A in 1991 elected to be rated double-A shortly afterward. That mortgage insurer's largest customers – the GSEs – had no preference and were willing to pay no value differential for triple-A rated MI insurance during the 1990s. Clearly the cost of maintaining a triple-A rating did not justify this zero value.

The decline in triple-A market share is for various reasons, many of them linked to the fact that the GSEs, in their current business practices, make absolutely no distinctions between triple-A and double-A rated MI companies. Even so, both remaining triple-A-rated companies have retained their rating, in part because both are subsidiaries of triple-A-rated parent companies and the cost of maintaining a triple-A-rating has likely been lower than that for a public company. However, as the rating agencies have adopted increasingly sophisticated models, this cost has steadily risen, and the decision to retain a triple-A-rating has grown more costly for the two remaining companies.

Our point is simply this: Any fear that the triple-A rated MI companies would suddenly dominate the industry is unfounded. A favorable haircut differential might, at best, stabilize the triple-A/double-A mix in the GSE portfolios. If – for any reason – there were a significant change, and it were truly a cause for concern, OFHEO would have ample time to react before the GSEs' in-force concentration changes in any significant way.

With regard to their MI counterparties, the September 13 final rule could have slightly changed the business practices of the GSEs to be more like that of private securities markets. The December 18 proposal may preserve the status quo environment – declining credit quality of insurer counterparties to the GSEs.

We make this point not because we think OFHEO should care what the market share of companies will be. It should not. It should care only that the GSEs place the appropriate value in seeking high-credit-quality counterparties. We believe that value is much greater than the zero value reflected in current GSE practices, and that *that* value would have been appropriately reflected and supported in the September 13, 2001 final rule.

Reduction in the Phase-In Period

On *Federal Register* page 47804 of the September 13, 2001 final rules, we find the following statement "OFHEO determined that phasing the haircuts in more quickly [five years] would be more consistent with the probable impact on counterparties of stress test conditions."

We agree with this original assessment by OFHEO. United Guaranty's internal high-LTV data suggest that, on a book year basis, stress scenario losses occur at ages 3 through 7, such that a five-year phase-in period of the haircuts would appropriately arrive at a time that would impact the recoveries of most defaulting counterparties.

Of course, the stress test scenario will apply to all in-force books in the GSEs' portfolio. The youngest books, those that have not had time to prepay, dominate the in-force. For example, the youngest four books of GSE high-LTV loans probably account for about four-fifths of the GSEs' high-LTV in-force exposure today. These are also the least seasoned books, and they will produce the majority of losses under a stress scenario. An analysis of a portfolio of multiple in-force books typical of GSE high-LTV loans produces the loss pay-out patterns shown in Table 2:

Figure 2: High LTV Loss Pattern of Multiple In-Force Books by Year

Stress Year	Annual Percent of Losses	Cumulative Percent of Losses	5-Year Haircut Phase-In	10-Year Haircut Phase-In
1	9.52%	9.52%	1.00%	0.50%
2	12.79%	22.31%	3.00%	1.50%
3	15.17%	37.48%	5.00%	2.50%
4	15.19%	52.67%	7.00%	3.50%
5	13.31%	65.98%	9.00%	4.50%
6	10.76%	76.73%	10.00%	5.50%
7	8.39%	85.12%	10.00%	6.50%
8	6.45%	91.57%	10.00%	7.50%
9	4.85%	96.43%	10.00%	8.50%
10	3.57%	100.00%	10.00%	9.50%
Average 10-Year Haircut			**6.90%**	**4.12%**

Source: United Guaranty Residential Insurance Company internal data on high-LTV loans. United Guaranty will make these and other data shown in this analysis available upon request.

The peak years of losses are actually years 3 and 4, with years 1–5 producing some two thirds of the losses. One would think that a counterparty would be most likely to default on its obligations when it is most stressed from the losses it is obligated to pay the GSE. This would certainly occur in years 1–5 when more than 65% of the losses must be paid (or in the case of derivatives, collateral posted).

In fact, we may even anticipate that by the end of year 5, both the GSE and the market have an accurate view of the year 6 losses (and probably year 7 as well). A derivatives counterparty *should* be required to pay or post as collateral all of the year 6 obligation (and possibly a good chunk of year 7), and an MI counterparty would have to set reserves for these losses. So by the end of year 5, at least 77% of the stress test obligations *should* have to be disbursed, reserved or collateralized by the counterparties. ***As a result, the vast majority of defaults by the counterparties will occur during this first five years as they are faced with the paying, reserving or collateralizing of 77% or more of the losses.***

So what does OFHEO, in its December 18 proposal, use to refute the years of work and the extensive data used in the September 13 final rule to argue for a 10-year phase-in? OFHEO uses a single cohort year, 1930, taken from the "recently obtained unpublished data from Moody's." OFHEO dismisses the entire body of research completed in the September 13 final rule with the comment, "This conservative approach takes into account that the interest rate shocks and the house price shocks all occur in the first half of the stress period."

While we do believe that most defaults will indeed occur within the first five years as discussed above, the September 18, 2001 final rule's five-year phase-in period does not require that they do. In OFHEO's own description of the application of mark-to-market practices of derivatives contracts, counterparties must post collateral for the value of *anticipated* future losses. Thus part or all of year 6 and 7 losses will most likely need to be collateralized in years 4 and 5. This is most likely to precipitate the defaults if they are to occur. We find it interesting that the same logic (collateralization) that OFHEO uses to justify favorable treatment of derivatives is virtually ignored when OFHEO sets its phase-in period.

Of final note on this subject, we could understand why OFHEO might have raised the phase-in period to six or possibly seven years, but 10 years was not supported by any reasonable data.

Effective Haircuts of the December 18 Proposal

Figure 2 also illustrates how a 10% haircut would be phased in under the OFHEO rules. The haircut is phased in on a monthly basis, and not having access to the actual working model, we approximated the average haircut in each year using a simple average. In year 3 of the stress scenario, the actual haircut is just 2.5% (or 75% below the final 10% haircut). In year 4, the actual haircut is 3.5% (or 65% below the final 10% haircut).

Using the expected loss pay-outs in each year as a weight, the average of the actual haircuts each year is substantially lower than the nominal haircut percentages quoted by OFHEO. A 10% ***nominal haircut*** (the haircut quoted by OFHEO) is an ***effective haircut*** (the average of the actual yearly haircuts as they are phased in) of only about 4% under a 10-year phase-in period. This is 60% less haircut than one might infer from reading the OFHEO

December 18 proposal. Under a 5-year phase-in period, as proposed in the September 13 final rule, the effective haircut is only about 30% less than the nominal haircut.

We think it interesting that OFHEO has never seen fit to publicly discuss the ***effective haircuts***, so we decided to take on the task.

Again, without a working model, we cannot calculate the numbers exactly. An examination of the *effective* haircut provides a clearer picture of the changes OFHEO has proposed than its discussion of the *nominal* haircut percentages. Figure 2 tells us that, under a five-year phase-in, the effective haircut is 69% as large as the nominal haircut shown by OFHEO, and with a 10-year phase-in, the effective haircut is 41% as large as the nominal haircut. We can use this relationship to construct Figure 3.

Figure 3: Nominal and Effective Haircut Changes Under the Proposed Rule

	Derivatives Counterparties		Non-derivatives Counterparties	
Nominal Haircuts				
	Final Rule	**Revised Rule**	**Final Rule**	**Revised Rule**
Triple-A	2%	0.5%	5%	3.5%
Double-A	4%	1.25%	15%	8.75%
A	8%	2%	20%	14%
Triple-B	16%	4%	40%	28%
Effective Haircuts – Adjusted for Incremental Phase-In				
	Final Rule	**Revised Rule**	**Final Rule**	**Revised Rule**
Triple-A	1.38%	0.21%	3.45%	1.44%
Double-A	2.76%	0.51%	10.35%	3.59%
A	5.52%	0.82%	13.80%	5.74%
Triple-B	11.04%	1.64%	27.60%	11.48%

Source: United Guaranty Residential Insurance Company.

Figure 3 reveals significant changes to the effective haircuts from the September 13 final rule. The haircut for triple-A-rated derivative counterparties is cut by a factor of 6 times. What is most amazing is that the factor for triple-B-rated derivative counterparties is cut by a factor of nearly seven times. ***Under the December 18 proposal, a triple-B-rated derivative counterparty gets the same capital treatment as a triple-A-rated non-derivative counterparty.***

One can see that the effective non-derivative haircut differential between triple-A-rated counterparties and double-A-rated non-derivative counterparties is a mere 2.15 percentage points. We believe this differential is insignificant to the GSEs. This is the point that OFHEO should be concerned about when referring to "inappropriate business decisions." There is no significant incentive for the GSEs to seek out higher-credit-quality counterparties under the December 18 proposal.

It is puzzling that nowhere in the December 18 OFHEO discussion is there any hint about the magnitude of the changes made so apparent by Figure 3. The discussion only of the nominal haircuts and the phase-in revisions without any evaluation of the impact or

significance of combining the two is simply misleading. In this light, how can OFHEO say that the impact is "not economically significant"?

Leverage Implications

It is difficult at best for interested parties to understand the implications of the OFHEO haircut differentials in its very complex capital model. In light of this, we sought a way to illustrate how the Figure 3 haircuts might translate into leverage ratios, something well understood in the financial industry.

To do this, we begin by assuming that the GSEs fully hedge or insure credit losses sustained under the OFHEO test. As a matter of practice, the GSEs usually retain a portion of the credit risk, but the cost to hedge or insure 75% or more of the risk would not be prohibitive for the GSEs, and we believe that they have done so on a number of occasions. In fact, it is possible for the GSEs to hedge 150% or 200% of the risk by the way the derivatives contract or insurance coverage is structured, and we know that on several occasions at least one GSE has contemplated doing just that. Thus far, without an actual model to test, we believe that there is nothing in the OFHEO model to prevent hedges of 150% or more.

We began with the Figure 3 haircuts and assumed that the GSE has credit exposure on high-LTV loans which it hedges with derivatives or insures with MI some 100% of the stress test credit risk. We can then estimate the implied leverage ratios by dividing the effective haircuts into 1.00, as shown in Figure 4.

Figure 4: Implied Leverage of Final Rule – Fully Hedged (or Fully Insured) Risk-to-Capital Ratio based on Effective Haircuts (December 18 Proposal)

	Derivatives Counterparties	Non-derivatives Counterparties
Triple-A	475 to 1	69 to 1
Double-A	195 to 1	28 to 1
A	120 to 1	17 to 1
Triple-B	60 to 1	9 to 1

Source: United Guaranty Residential Insurance Company.

The implied leverage of the proposed haircuts for derivative counterparties is clearly excessive. It demonstrates the very generous nature of the haircut percentages for derivatives counterparties.

On an overall basis, the minimum capital requirements would kick-in long before these leverage levels are reached, but this provides no comfort. With other, lower-leveraged products averaging out their portfolios, the GSEs could view the incremental leverage of a new product to be just exactly that shown in Figure 4. If GSE marketplace behavior reflected these leverage ratios underlying their incremental analyses – including their risk tolerance, expected returns and resultant pricing objectives – the behavior of these giant corporations in segments of the marketplace could be predatory and exclusionary of private market competitors. This is the kind of "inappropriate business incentives" that we believe OFHEO was chartered to prevent.

Interest Rate Derivatives versus Credit Derivatives

In the December 18 proposed revisions, OFHEO uses interest rate derivatives in all of its examples that it cites in attempts to justify its favorable treatment of derivatives. Even so, OFHEO continues to be silent or ambiguous regarding whether it would treat credit derivatives – which share almost none of these favorable characteristics – under the same rules as interest rate derivatives. MICA has repeatedly requested, in both written commentary and in meetings and conversations, that OFHEO clarify its intent as regards credit derivatives. United Guaranty strongly agrees with the MICA position on obtaining this clarification. Given the very lenient details of the December 18 proposal, we are extremely concerned that OFHEO has not made this important distinction.

For example, OFHEO states, "To develop loss severity rates for defaulted derivative contracts, OFHEO examined changes in Treasury security interest rates over periods of ten business days during the past 25 years". In the subsequent paragraph, OFHEO states, "During the stress period, net derivative cash flows are related to changes in the ten-year Treasury yield – 75 percent in the up-rate scenario and 50 percent in the down-rate scenario" [page 65148]. In fact, the entire discussion, as well as the bulk of the discussion in the September 13, 2001 final rule, relates exclusively to interest rate derivatives.

MICA and United Guaranty have on multiple occasions pointed out the differences between highly liquid interest rate derivatives that can be marked-to-market on a weekly or daily basis and credit derivatives, which are almost exclusively one-off deals and, by their very nature, will remain so in the foreseeable future. Perceptions of credit risk trends in a portfolio vary with long-term real estate cycles and are totally unrelated to typically short-term interest rate cycles. Most of the assumptions OFHEO makes with regard to interest rate derivatives are not valid for credit derivatives.

United Guaranty strongly believes that OFHEO needs to clarify that the haircuts for derivatives counterparties apply only to interest rate derivatives until OFHEO can specifically develop rules for credit derivatives. We see no reason why the interim treatment of credit derivative counterparties should be any different than the treatment of non-derivative counterparties throughout the final rule.

Derivatives – Actual Collateral Versus a Promise to Collateralize

United Guaranty clearly understands and supports OFHEO's desire to provide strong capital incentives for the GSEs to hedge their enormous interest rate risk positions in an efficient and prudent manner. We understand that the public interest for the GSEs to significantly hedge this risk is likely to be greater than the demands of the GSE stockholders, hence strong capital incentives may be called for. Notwithstanding these desirable objectives, we are concerned that illogically favoring all derivatives contracts over other risk reduction contracts may have unintended consequences and ultimately be unfair to the insurance industry.

The final rule provides for lower haircuts for interest rate derivatives than for non-derivative contract counterparties or instruments. This seems solely justified by the argument that interest rate derivatives are "collateralized." With time, this argument will unfortunately be proven falsely optimistic. We hope OFHEO will examine this logic carefully and reconsider its position quickly.

Basically, the argument fails to distinguish between actual collateral and a promise to collateralize. We fully support and cannot argue with any rule that would treat as cash equivalent any portion of a derivative that is composed of (or projected at the beginning of the stress test period to be composed of) actual collateral. However, we do not agree with the current final rule, which imposes reduced haircuts (relative to other counterparties) for a mere *promise* to collateralize.

Treating a promise to collateralize by a derivative counterparty more favorably than a promise to make a claim payment by an insurer is unfair to the insurance industry relative to the securities/investment industry. The two promises, if identical in other respects, should be treated identically. Anything less than this is an arbitrary and illogical predisposition against the insurance industry and we vigorously oppose such treatment.

OFHEO may have some ground in the case of very short-term interest rate hedges such as pipeline risk hedges, in which the value of the contract is marked-to-market daily and collateral may be adjusted accordingly. On a short-term basis, the promise to collateralize may be argued to be unlikely to be affected by changes in the counterparty's financial condition and rating. Of course, we would want short-term insurance contracts to be treated similarly (and these do exist).

However, in the case of longer-term hedges, which may include out-of-the-money hedges and credit risk hedges (which by the nature of the risk are long-term), the promise to collateralize may be many months or years into the future and presents no different risks to the GSEs than an insurer's promise to make claim payments over a similar time frame. OFHEO should treat interest rate derivatives and other contracts equally, giving appropriate investment treatment (based on collateral maturities) for actual collateral posted at the beginning of the stress periods. However, any promises to collateralize or settle during the stress period should be based on uniform counterparty risk haircuts regardless of the classification of the contract as an interest rate derivative or insurance contract.

OFHEO places excessive faith in the abilities of the GSEs and their derivatives counterparties to maintain models that accurately predict derivative values based on future risks. Highly accurate models simply do not exist. There is no evidence that these models will perform under stress-scenario derivative price shocks. ***The failure of derivatives valuation models has been cited in numerous studies as contributing to the collapse of a number of firms including LTCM and possibly Enron.***

In fact, a crucial assumption implicit in the OFHEO acceptance of the derivatives collateral is that the derivatives valuation models correctly anticipate the stress scenario at all times. If instead, the market (and models) were expecting the continuation of an expansion (as is often the case before a real estate down cycle) and sudden "shocks" affected the markets, the previous valuations will be materially wrong and the collateral could be radically changed in a short period of time (days).

While we very much understand OFHEO's strong desire to encourage greater use of interest rate derivatives, this desire should not come at the expense of logical risk assessment. Arbitrarily favoring one type of instrument over another can create many unintended market distortions. In particular, favoring the highly volatile derivatives markets over more stable

and long-term insurance markets could have unintended negative consequences for the GSEs' long-run credit risk management efficiencies.

Derivatives with a Triple-A Rating

The GSEs typically do not require (nor does OFHEO in its commentary) that triple-A-rated derivative counterparties post collateral. The posting of collateral to meet the mark-to-market requirements of derivatives contracts has consistently been OFHEO's only argument for treating derivative counterparties differently from non-derivative counterparties. ***So we ask, what is OFHEO's justification for treating triple-A-rated derivatives counterparties differently from triple-A-rated non-derivatives counterparties?*** In both cases, the GSE is relying primarily on the financial strength of the counterparty in meeting its obligations. Should not these haircuts be the same?

Derivatives – Lessons from LTCM

We think the OFHEO preference for derivatives is dangerous given the wealth of information now available about a number of institutions that have failed as the result of their derivatives activities. These include Enron, LTCM, Barings PLC, Metalgesellschaft and Drexel Burnham Lambert. The Enron debacle is too recent to have created a body of literature, but the LTCM fund was studied by a number of government experts and the literature is full of lessons that OFHEO should consider.

We specifically examined three reports dealing with the LTCM failure:

- The GAO's October 1999 report to Congressional Requesters, titled *Long-Term Capital Management, Regulators Need to Focus Greater Attention on Systemic Risk*.
- The March 2000 report by Financial Stability Forum (FSF) to the IMF and World Bank, titled *Report of the Working Group on Highly Leveraged Institutions*.
- The April 1999 report by the President's Working Group on Financial Markets (PWGFM), titled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*.

The net asset value of LTCM declined from about $4.67 billion on December 31, 1997 to $2.3 billion by August 31, 1998. On August 21, 1998, LTCM had a single day trading loss of $550 million. The size of the total loss at LTCM was a fraction of the amount Fannie Mae has lost on derivatives activities (presumably offset by earnings or long-term gains on its other business activities) in just the third quarter of 2001.

We think there are enough parallels between the risks of LTCM and those of the GSEs to warrant a close examination of the papers on LTCM. Of course, we do not believe that either of the GSEs is anywhere close to being an LTCM disaster. They are both currently managed much better than that. Yet they are both trying to maintain earnings growth much in excess of the growth in U.S. real estate assets, hence future management will be under enormous pressure to maintain that earnings growth. What risks they might take with inappropriate business incentives from OFHEO are of concern to us. Thus, we think it is critical that OFHEO considers the lessons learned from highly leveraged institutions like LTCM.

The FSF's March 2000 paper makes some interesting conclusions as regards high leverage that we think are worth intense scrutiny by OFHEO:

> Leverage also enables firms to take larger positions than would otherwise be the case in a given asset or market. Unwinding large positions can further amplify price movements and raise market volatility. This in turn can have unpredictable consequences for the behavior of prices in other markets and hence for a firm's own positions, and those of counterparties. Arguably, some of these risks can be increased when leverage is provided through more complex instruments. [page 15]

As is evident from this discussion, the FSF paper describes the effects of a counterparty insolvency (LTCM) on a financial institution. The LTCM paper frequently uses a word that you will not find in the OFHEO texts, "shock." For sudden movements of derivatives positions are indeed "shocks" to an enterprise. What is also apparent about the LTCM insolvency as discussed in the FSF paper, but overlooked by OFHEO, is that if a firm has very large positions in the market, then unwinding those positions can impact the market itself, and in a negative direction to the firm's own positions.

Here is how the PWGFM paper addresses the issue:

> A related concern is whether the LTCM Fund's counterparties were lulled into a false sense of security based solely upon their collateral arrangements with the Fund. Counterparties' current credit exposures were in most cases covered by collateral. However, their potential future exposures were likely not adequately assessed, priced, or collateralized relative to the potential price shocks the markets were facing at the end of September 1998, and relative to the creditworthiness of LTCM at that time. Further, expectations about the ability to collect on collateral calls were probably unrealistic for an entity like the LTCM Fund, particularly in the market environment of last Fall. Thus, counterparties that were relying on variation margin to manage credit risk were left with the unsatisfactory prospect of liquidating collateral and closing out exposures in a declining market. [page 15]

In fact, if a GSE were to experience a default with a counterparty on $50 billion in notional value of derivatives, the replacing of that large a position would indeed impact the market itself – in a big way. As the FSF paper puts it, "As revealed by the events of the autumn of 1998, the complexity of risk exposures and their interactions can make it extremely difficult for a firm to assess the consequences of a price shock for counterparties' creditworthiness and the firm's own credit exposures." [page 15] This is the opposite philosophy from what appears in the December 18, 2001, OFHEO paper.

Realistically, under stress test conditions resulting in derivatives price shocks, the GSEs cannot possibly replace any large defaulted counterparties' positions within a 10-day window at anywhere near the value of the collateral that was posted prior to the default.

The GAO report [page 39] contains a timeline of how quickly conditions worked against LTCM. The first potential triggering event was a decision by Salomon to disband its arbitrage unit and sell certain trades on July 17, 1998. This adversely affected a number of LTCM positions. On August 17, 1998 the Russian government devalued the ruble and declared a debt moratorium (default) which triggered an investors' flight to quality. By

September 2, 1998, LTCM was informing investors that it had lost over half of its capital and by mid September the Federal Reserve had intervened to salvage the financial mess.

The PWGFM paper notes:

> Overall, the distinguishing features of the LTCM Fund were the scale of its activities, the large size of its positions in certain markets, and the extent of its leverage, both in terms of balance-sheet measures and on the basis of more meaningful measures of risk exposure in relation to capital…. For example a number of the Fund's futures positions represented more than five percent of open interest, and in a few cases, well above ten percent. [page 11]

The GSEs' risks will move in tandem because they are basically hedging similar business risks. Combined, their very large size presents enormous systemic risk to financial markets. Thus, we think that OFHEO needs to consider the size of the GSE's combined positions in the various derivatives markets when considering whether they are adequately collateralized in the event of significant shocks to derivatives prices. ***This size will inevitably cause the markets to move against the GSE positions if they are forced to replace defaulted counterparty positions.***

Collateral Flaw in OFHEO Derivatives Approach
In its December 18 proposal, OFHEO states that:

> OFHEO proposes to maintain, with alteration, special treatment for derivative counterparty exposures. Current exposures are marked to market at least weekly, and high quality collateral is posted against any significant exposures by counterparties with less than a triple-A rating. The Enterprises retain the right to require substantial over-collateralization or to transfer the contract to a new counterparty if a counterparty's rating is lowered to low investment-grade levels or worse." [page 65148]

Again, OFHEO cites repeatedly the value of collateral in supporting its favorable treatment of derivatives counterparties over non-derivatives counterparties. But strangely, OFHEO provides no specific details about how much collateral the GSEs actually hold against their derivatives risk.

In its supplement dated November 14, 2001, Fannie Mae indicated that it held derivatives with notional amounts totaling some $474 billion as of September 30, 2001. Fannie reported that just eight counterparties (rated A or better) held approximately 81% of the total notional balance. If our math is correct, that is $384 billion, so on average Fannie held with each of the eight counterparties an average notional amount of outstanding derivatives transactions with Fannie Mae of a bit under $50 billion each. Fannie reported that each of the eight counterparties was rated A or better.

Fannie also reports that it was in a gain position (estimated by Fannie to be a positive cost of replacing those contracts at market value) on some of its derivatives contracts. "Fannie Mae's gross exposure (taking into account master settlement agreements, but not collateral received) was $73 million at September 30, 2001 . . ." Fannie also reports that it held $31 million of collateral through custodians for derivative instruments at September 30, 2001. By our math, they held collateral equal to just 42% of their actual market exposure.

We have to ask, how can this level of collateralization justify allowing a leverage of 195 to 1 (for double-A-rated counterparties) or 120 to 1 (for A-rated counterparties)? Note also that this is the gain as of a certain point in time, in this case as of September 30. It is not the gain that could occur, say over a 10-day period of derivative price shocks.

Even worse, consider Fannie Mae's $31 million in total collateral against the total notional value of $474 ***thousand*** million. This collateral amounts to just ***65 one hundredths of one basis point*** of the notional amount. How can OFHEO possibly argue that this collateral will amount to any significant protection for the GSEs to their counterparty credit risk in the event of a significant shift in interest rates and the value of these derivatives?

We realize of course that the notional amount does not by itself present a proportionate picture of the risk embedded in the derivatives portfolio, so we looked at the Accumulated Other Comprehensive Income (AOCI), a balance sheet adjustment required by FAS 133. The AOCI reflects the cumulative losses/gains that Fannie Mae incurred on its derivatives portfolio, without the offsetting gains/losses it incurred on the corresponding risks that Fannie Mae is hedging with these derivatives. Fannie Mae's AOCI moved from a negative $3.5 billion on June 30, 2001 to a negative $10 billion on September 30, 2001. This reflects a loss of approximately $6.45 billion during the third quarter of 2001 on Fannie Mae derivatives activities.

This loss probably reflects a quarter in which interest rates moved significantly in Fannie's favor on its normal business risks and balance sheet accounts – the derivatives hedges would have acted properly by moving in the opposite direction to stabilize earnings. Indeed, Fannie Mae had a good earnings quarter (of course some of the movement of the hedges may be to offset earnings that will not appear until the future.)

So we think it reasonable to assume that in another quarter, say an equally bad quarter for Fannie Mae's normal business risks, as in a stress test scenario, the value of the Fannie Mae derivative positions could have gained $6.45 billion. We know that interest rates, on a daily basis, fluctuate quite a bit during a typical quarter, so that probably Fannie would have derivative gains on perhaps just 60 of the 90 days during the quarter. That means on an average good day, Fannie could gain $107 million from its counterparties.

Yet the $31 million in collateral that Fannie held on derivatives as of September 30, 2001, amounted to just 29% of the derivatives gains Fannie could expect to realize against its counterparties in a single day. This collateral would be just 2.9% of the movement one might expect over a 10-day period of derivative price shocks. As OFHEO states in the December 18, 2001 proposal, "Thus, the principal risk is that a relatively highly rated counterparty may fail suddenly and that exposures rise between the time a contract was last collateralized and the time the Enterprise takes action to transfer or replace the contract. This period may be as much as ten business days."

So we must ask, is collateralization of just 2.9% of the 10-day exposure – or just 0.000065 of the notional balance, or 42% of one day's market exposure – by any of these measures sufficient collateral for treating risk hedged by derivatives only slightly less favorably than cash? We think this treatment fails any reasonableness test that can be construed, given the

GSEs' actual collateralization practices and certainly offers no material advantages over comparable insurance instruments.

Finally, we think OFHEO is too vague in its rules about the nature of the collateral. Many of the types of collateral that could be posted are themselves interest rate sensitive. Clearly, if one reads the many reports on the problems of the LTCM crises, the collateral risk is *very* material to the GSE. Again, the reality of collateral values under stress does not support OFHEO's favorable treatment of derivatives counterparties.

Unrated Seller/Servicers

The September 13 final rule treated unrated seller/servicers as triple-B-rated counterparties. Frankly, we thought this was a bit of a stretch as Fannie Mae and Freddie Mac routinely make business decisions to approve seller/servicers that are quite small and financially unproven. The abbreviated comment period does not provide time to verify this, but we would hazard a guess that Superior Bank, which failed in 2001, was an approved GSE seller/servicer until very recently. We would like to ask OFHEO if in fact Superior Bank remains an approved seller/servicer with either of the GSEs today.

According to Fannie Mae's November 14, 2001, financial conditions supplement, the GSE held some $12 billion in recourse with providers that were not investment grade as of September 30, 2001 (39% of the total of $31 billion in single-family loans backed by recourse arrangements). The supplement goes on to state that Fannie Mae "mitigates the risk associated with recourse transactions through various means, including requiring lenders to pledge collateral to secure their obligation."

Again, we ask the question: Is a rule which allows Fannie Mae to possibly upgrade its haircut treatment on $12 billion in recourse "not economically significant"?

We also object to the tying-in of this standard to the approval of the seller/servicer for the GSEs' Delegated Underwriting and Servicing (DUS) Programs, which are in turn linked to their proprietary automated underwriting systems (AUS). There seems to be no reason consistent with GSE safety and soundness to tie this rule in with the DUS and AUS programs. We believe this further entrenches the GSEs in their strategy to become the sole U.S. providers of AUS. Both GSEs have reported sharply higher fee income over the past year because of their "duopoly" on these systems.

In addition, the use of a 1% collateral standard for unrated seller/servicers to receive a rating as high as double-A seems inappropriate. Clearly, the OFHEO stress test model would indicate that many portfolios will produce defaults vastly in excess of a 1% balance. Again, we have not had sufficient time to analyze this particular rule, but it seems surprisingly counter to normal safety and soundness concerns.

Many Other Aspects of the December 18 Rule

There are a number of other changes contained in the December 18 rule, that we simply do not have the time to analyze in what is effectively a 15-day comment period. These include the recovery rates, derivatives loss severity rates, the interim haircuts prior to netting, the proposed changes to yields on enterprise data, modification to prepayments in the down rate

scenario and the mix of long-term and short-term debt. We also do not believe we have had adequate opportunity to research fully those issues we have commented on.

V. What OFHEO Did Not Change in the December 18 Proposal

We would like to comment on three shortcomings in the final rule, which favor the GSEs and which OFHEO chose to overlook in the December 19 proposal. These are the final rule treatment of structured mortgages, spread accounts, and the expedited rules for new products.

Structured Mortgages

The first of these is the treatment of the structured mortgage, such as the 80-10-10. For an 80-10-10 mortgage, allowing the GSEs to include the 80%-LTV first mortgage in the same risk bucket as an 80% LTV first mortgage with no second mortgage is a severe understatement of the frequency risk of this growing segment of the GSEs' portfolios. In the final rule, OFHEO cited the inability of the GSEs to track this information. However, it is a required input to all of their automated underwriting systems and it is on the standard application. We would not object if OFHEO were to set a guideline to begin tracking these loans on June 1, 2002, as long as it gets done. The GSEs have ample resources and existing data fields to capture and track these loans.

A similar concern is the very-high-LTV mortgages, typically made at 97% and 100% LTVs. The model defined by the final rule does not fully account for the risk presented by these very-high-LTV mortgages. As with the structured mortgages, no one has retained the risk on these mortgages for a period sufficient enough to precisely measure their behavior to maturity.

OFHEO's final rule that lumps these products into categories for which they were not designed (such as lumping 80-10-10s structured first mortgages into the risk buckets for 80%-LTV mortgages and lumping 100%-LTV mortgages into the same risk buckets for 95%-LTV mortgages) is unacceptable and dangerous. Both products are too significantly represented in the GSEs' portfolios and have a risk profile too obviously unique to be prudently classified in this manner. Both products are rising as a percentage of the GSEs' risk positions, and the model error will grow each month.

Spread Accounts

As a substitute for other forms of credit enhancement, spread accounts have been periodically encouraged by the GSEs whenever the market perception of mortgage default risk is extremely low as during the early 1980s and mid 1990s. Generally, when actual default losses suddenly reduce spread account attractiveness to lenders and the GSEs, this vehicle becomes quite scarce in the marketplace. We were pleased when NPR2 took a conservative approach to spread accounts and allowed for only the actual accumulated collateral to be used as an offset to losses during the stress period.

The final rule, however, came out diametrically opposite to NPR2. And the final rule is very generous relative to the GSEs' own valuations of excess servicing spreads.

The final rule allows for 60 months of future spread account cash flow to be counted immediately as cash available to pay for GSE stress test losses. In reality, the cash would become available only ratably over five years and we regard this to be a significant and unacceptable flaw in the timing of the cash flows in the OFHEO model. Allowing 60 months to be counted up front may have been a hasty attempt to provide a present value to a longer stream of spread account cash flows. Again, this falls significantly short of reality.

Current market valuations of similar excess servicing cash flows reflect the uncertainties of the future payments due to mortgage prepayments, principal pay-downs, amortization and defaults, as well as the time value of money. The GSEs purchase these flows routinely and have typically valued them at the equivalent of 24 to 48 months. Why would OFHEO use such a significantly higher value in its capital assessment? Aggravating this shortcoming, spread accounts may also allow for a cessation of payments due to agreed-upon maintenance balances being reached, further lowering the NPV value of the flow. The OFHEO model allows for the undiscounted value of this maintenance balance to be used as a ceiling to the spread account value, again an oversight favoring less GSE capital.

Allowing the GSEs to essentially capitalize this spread income at such a high multiple for purposes of determining stress-test model required capital is virtually the same calculation error that precipitated the recent demise of a thrift, Superior Bank. Another similar calculation error resulted in a $1.5 billion write-off for the Australian owners of one of the nation's largest mortgage seller/servicers. We continue to be amazed that a calculation which has been responsible for so many recent and public mortgage debacles has gotten so far into the OFHEO regulations.

Again we do not want to suggest specifically how OFHEO should treat spread accounts. It would appear logical to value them in the same way OFHEO values Guarantee Fee revenue. If a more simple approach is desired, a 30-month recognition spread over 2.5 years might be a conservative solution, and we are sure there are other reasonable approaches.

Expedited Rules for New Programs and Products

In the final rule, OFHEO reiterated its position to facilitate GSE innovation by making quick responses to new products. As a result, the innovations themselves and the OFHEO corresponding capital treatment may not be visible to the public. This may be an appropriate procedure for mission-critical activities, such as new affordable housing programs, new loan instruments, or new secondary market innovations. However, in the arena of products whose primary purpose is to manage OFHEO capital requirements, we believe that a more cautious and transparent approach is necessary.

VI. Summary

OFHEO's proposed modifications are very significant. They reduce and narrow counterparty haircuts in every ratings category. They double the length of the haircut phase-in period so that the counterparty risk haircuts will have little effect on expected recoveries. They allow non-investment grade counterparties to enhance their contracts to receive the same haircut as double-A counterparties. These are the same provisions that, in earlier presentations, the GSEs indicated could reduce their required capital by billions of dollars.

The changes in the haircut rules all appear to reduce required GSE capital. Of course, this means less capital between the U.S. taxpayer and the various derivatives activities, leveraged debt and real estate exposures of the GSEs.

Other significant changes include treating collateralized derivative contracts only slightly less favorably than cash. In the written rule justifications, OFHEO seems oblivious of the lessons so recently learned from insolvencies of the recent past: Enron, Drexel Burnham Lambert, Barings PLC, Metallgesellschaft, LTCM, and others. These were all highly leveraged institutions exposed to substantial interest rate risk, credit risk, or derivatives risk. The GSEs are exposed to all three. Treating these derivatives as cash should be done only under the most intense scrutiny. OFHEO seems unwilling to acknowledge how quickly interest rate and credit risk perceptions can change the market value of derivatives, which could quickly exceed GSE internal model assumptions about collateral values and, therefore, OFHEO's assumption about the cost of replacements to contracts in default.

In summary, publishing "final" rules after nine years and then amending them just three months later, imposing an abbreviated 30-day comment period, and providing no quantitative information regarding the impact of those rules makes a mockery of the public review process. If the impact has been measured by OFHEO and reported to OMB behind closed doors, it must be made public. Otherwise, the implementation of these rules should be delayed until the magnitude and appropriateness of the changes can be evaluated in a quantitative manner. Finally, a comment period of just 30 days is entirely inappropriate to fully examine and evaluate the so-called improvements.