January 17, 2002

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

RE: Proposal to Amend Appendix A to Subpart B of 12 CFR Part 1750 Risk-Based Capital

Dear Mr. Pollard:

The Mortgage Insurance Companies of America (MICA) appreciates the opportunity to comment on OFHEO's proposal to amend parts of the final risk-based capital rule. Our specific comments are outlined below.

Impact of Risk-Based Capital Rule

At the outset, MICA would like to urge OFHEO to advance its assessment of the quantitative impact of its risk-based capital rules and the release of this assessment to the public. Although the complexity of the model may make it difficult to complete a total run of the new rules for some time, we assume that OFHEO has preliminary models that have permitted it to evaluate internally the impact not only of the final rule, but also of the revised changes as set forth in this latest proposal. Congress required that the risk-based rules be transparent, and public release of OFHEO's quantitative impact assessments would help to bring the rule into compliance with that requirement.

Haircuts for Unrated Seller/Servicers

We are very concerned with a proposed revision to the rule which would permit unrated seller/servicers to be treated the same as AA-rated credit risk counterparties as long as the

GSEs have approved them as users of automated underwriting systems and a tiny amount of credit enhancement is obtained. We understand that OFHEO intended that this approach apply only to seller/servicers of multifamily mortgages who participate in certain multifamily programs and that seller/servicers of single-family residential mortgages will not be eligible for this treatment. It is important that OFHEO make this restriction clear in the final rule if it intends to follow this approach for multifamily seller servicers. However, there are important reasons why this approach should not be used for either single or multifamily purposes.

Seller/servicers are the primary counterparty risk for both Enterprises. Allowing unrated seller/servicers to achieve the equivalent of a AA-rating through the use of an Enterprise's automated underwriting system and minimal third-party support undermines the entire ratings-based rationale of the risk-based capital rule.

In our comments on the proposed risk-based capital rule in March and April of 2000, MICA provided a detailed analysis of the problems with the then-proposed low haircuts for unrated seller/servicers. We argued then – and strongly believe now – that treating unrated seller/servicers as if they had an investment grade rating will create a strong capital incentive for the GSEs to transfer credit risk protection from highly-rated, well-regulated concerns to far more risky counterparties. This will, in turn, result in the type of regulatory capital arbitrage that bank regulators are now seeking urgently to correct in the capital rules governing insured depositories and their holding companies.

Importantly, access to the Enterprises' automated underwriting systems is in no way a substitute for the type of extensive regulation and significant capital requirements imposed on the mortgage insurance industry and other rated credit-risk counterparties. The minimal third-party support for unrated seller/servicers to

achieve a AA rating under the rule in no way mitigates the very substantial risk associated with this proposal.

We continue to believe that allowing unrated seller/servicers to be treated under the risk-based capital rule as if they had an investment grade rating both undermines the ratings-based foundation of the rule and will prove risky to the GSEs. We further believe that allowing unrated single or multifamily seller servicers to be treated under the risk-based capital rule as if they had a AA-rating through the use of an agency's AU system and minimal third-party support will exacerbate this danger.

Credit Derivatives

In earlier comments, MICA has urged that OFHEO carefully consider the ramifications of credit derivatives and permit their incorporation into the risk-based capital model only after detailed review through a formal rulemaking. We very much appreciate the September 17, 2001 letter from Director Falcon to MICA President Curt Culver, in which Mr. Falcon stated that OFHEO will pursue a public rulemaking prior to allowing risk-based capital credit for any credit derivatives used by the GSE. We believe that the current concerns of the financial community with counterparty risk inherent in untested credit derivatives reinforces Director Falcon's decision as expressed in this letter, and we urge OFHEO to make this clear to the GSEs and the public at large through a formal indication of OFHEO policy on credit derivatives in the final rule.

These derivative instruments and the counterparties behind them have been untested during periods of prolonged economic stress, and may only now be facing the beginning of an extended stress period. Additionally, the way in which OFHEO chooses to treat credit derivatives will have an impact both on other forms of risk protection utilized by the Enterprises as well as mortgage market participants.

Spread Accounts

The treatment of spread accounts in the final rule is a radical departure from NPR2 and is inconsistent with the rest of the risk-based capital regulation. Director Falcon also noted in his September 17, 2001 letter to Curt Culver that OFHEO does not allow spread accounts to be used by the GSEs to replace charter-required credit enhancement for high loan-to-value mortgages. He stated that this is the intent of Footnote 151 in the final rule, but we urge OFHEO to include in its pending revisions a rewrite of this footnote to make this clear to all interested parties.

Although we would strongly support this clarification, we remain concerned with the capital treatment of spread accounts. The final rule continues to include very unrealistic assumptions about the structure and performance of spread accounts and, as a result, provides over-favorable treatment for them.

The overvaluation of excess servicing (interest only strips) has been a major contributor to recent financial problems with a number of lenders. It has been cited by the FDIC and OTS as a major contributor to the failure of Superior Federal Savings Bank this year and the collapse of Keystone National Bank and Pacific Thrift and Loan in 1999. This also has been cited as a contributor to the $1.5 billion write down at Homeside Lending, one of the largest mortgage servicers in the United States. Excess servicing and, by implication spread accounts are clearly very volatile assets where the cash treatment proposed in NPR2 would seem much more appropriate and prudent than the liberal treatment given them in the final rule which remains unchanged by this latest proposal. In the event that treating the spread account payments the same as guarantee fee revenues in the stress test proves too complex for immediate application, MICA has recommended to OFHEO that the spread account be valued at 30 to 36 months of income (minus the collateral already

accreted in the case of minimum balance spread accounts) until such modeling can be done.

Structured Loans

The proposed rule does not remedy the serious error in the final rule as regards structured loans. In our response to NPR2 and in other comment letters, we urged OFHEO to use combined, rather than primary, LTV in categorizing loans for the risk model. MICA believes that, contrary to the assertions of the agencies, structured loans present an increased credit risk to the agencies and that the agencies have sufficient data to enable OFHEO to properly account for that risk in the risk-based capital model. Indeed, we understand that the GSEs vary their pricing to lenders when there is a structured loan, making it clear that this data is available.

Data suggest that structured loans with a given combined LTV perform worse than equivalent single loans with the same LTV. In response to the suggestion of one GSE that the additional risk of structured loans is offset by improved credit, MICA notes that, in the final rule, OFHEO rejects the role of borrower credit risk in determining default or prepayment risk. Furthermore, evidence from mortgage insurance data suggests that credit scores are, on average, lower for loans with secondary financing than for loans without it.

The impact of the final rule’s treatment of subordinate financing is to create a major loophole for the agencies to increase their risk without compensating capital. MICA urges OFHEO to bring the treatment of structured loans up to the standards of the rest of the rule by treating such loans on a combined LTV basis, thus increasing the LTV for purposes of the capital rule on the first liens to that of the total financing.

Relative Non-Derivative Counterparty Haircut Levels

In response to NPR2, MICA provided written comments outlining numerous reasons for an

improved treatment of MI companies in general, and a narrowing of the differential between the haircut given to AA-rated MI companies as compared to AAA-rated MIs. We will not attempt in this letter to revisit all of the arguments we have made regarding the extensive data that support a narrowing in the differential between AA haircuts and other rating categories. We appreciate your review of the historical data concerning relative default rates and your decision to reduce the differential between the assumed cumulative default rate for AAA and AA – rated counterparties.[1] However, we believe that OFHEO has not sufficiently reduced the differential between the effective AAA and AA counterparty haircuts to reflect historical experience.

MICA has reviewed the historical data that shows an average relative default rate for AA-rated issues that is only 27% greater than that for AAA-rated issues. This compares to the 150% implied by the default rates in the latest proposal. We understand that the approach taken by OFHEO in the new proposal to apply 70 percent severity rates to non-derivative counterparties effectively reduces the AA-rated counterparty haircuts to 8.75% versus 3.5% for AAA-rated counterparties. However, we continue to believe that it would be more appropriate to use the average of spreads as shown in all the studies surveyed, and reduce the haircut multiple for AA versus AAA counterparties to no more than 27% versus the 150% in the current proposal. Private mortgage insurers have paid more than 99.87% of

[1] This comment letter from the Mortgage Insurance Companies of America regarding non-derivative counterparty haircut differentials applicable to AAA and AA-rated entities and instruments does not reflect the view of American International Group, Inc., the parent of United Guaranty Corporation and GE Capital, the parent of GE Mortgage Insurance., each of which is rated AAA.

all valid claims in the 44-year history of the modern industry. Clearly, the haircuts applied to both AAA and AA-rated private mortgage insurers are far too high.

Sincerely,

Suzanne C. Hutchinson