

January 17, 2002

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

RE: Proposed Revisions to the Risk-Based Capital Rule

Dear Mr. Pollard:

On behalf of the General Electric Mortgage Insurance Corporation (“GE”), we write to express our deep disappointment with the “proposed improvements” to the final risk-based capital rule (the “Final Rule”) published by the Office of Federal Housing Enterprise Oversight (“OFHEO”) on December 17, 2001. As you are aware, GE invested considerable time and effort to (1) make detailed comments to OFHEO during the Second Notice of Proposed Rulemaking (“NPR2”) process, and (2) meet with OFHEO officials on several occasions to provide our thoughts and concerns regarding the risk-based capital rule. GE has been a strong supporter of a capital rule that gets the capital right.

As we have previously stated, the GSEs provide stability and liquidity to the U.S. mortgage market. Implementing the Final Rule published in September in a timely fashion would have enhanced that stability and liquidity and ensured that the domestic mortgage market remains vibrant and sound. Unfortunately, the subsequent “proposed improvements” have significantly weakened the Final Rule.

We therefore strongly recommend that OFHEO withdraw the proposed changes to the Final Rule until: (1) the Final Rule has become effective, (2) OFHEO calculates, and the GSEs are in compliance with, the capital requirements under the Final Rule, (3) OFHEO makes available a working model of the Final Rule, (4) OFHEO quantifies the capital impact of each proposed change on both Fannie Mae and Freddie Mac and (5) OFHEO employs a formal rulemaking process, with adequate time to comment, to address any improvements which OFHEO thinks may be needed. We are concerned that OFHEO has presented no compelling data or justification for proposing these sweeping changes, which we believe will result in a massive reduction in GSE risk-based capital and a massive disruption to the mortgage insurance industry.

However, in the event the above recommendations are not followed, we are submitting the following comments to address certain aspects of OFHEO’s proposed improvements to the Final Rule. As in past GE comment letters, our analysis is based on the best available data, which is consistent with Congress’s purposes and provides alternatives that more closely tie capital to risk.

Our comments focus on three areas:

First, the **regulatory process** and access to key data since the release of the Final Rule has been inadequate. Despite careful attention to the process, major analytical revisions (such as incorporation of the recovery values in the counterparty haircut determinations) have reappeared without any notice. And, since the proposed changes were published on December 17 in the “proposed improvements amendment” (the “Amendment”), there have been delays regarding the availability of critical data mentioned in the Amendment, a complete lack of disclosure of how the proposed changes would effect GSE capital requirements, and a refusal to consider any extension of the comment period that effectively diminishes the ability of interested parties to better understand and thoughtfully discuss the proposed changes. While we all look forward to the implementation of an appropriate capital rule, OFHEO’s sudden desire, after nearly 10 years of careful preparation, to rush several significant proposed changes through the system with only a 30-day public comment period can only undermine public confidence in the Final Rule and in OFHEO as a regulator.

Second, the Amendment's **technical revisions** are substantively flawed in their approach to counterparty haircuts regarding default data, the concept of recovery values and the extension of the haircut phase-in period to 10 years. While we will describe how we believe the data relied on by OFHEO might be used more constructively, we respectfully suggest that any response by OFHEO to the comments offered to the Amendment start by answering four essential questions:

- How much less capital will the GSEs have to carry as a result of the Amendment?
- Did OFHEO intend to create a counterparty standard that the GSEs and equity analysts have described as making the GSEs indifferent as to whether its mortgage insurance providers carry a AA or AAA standard of financial strength?
- Given an acknowledged lack of market discipline available to temper GSE actions, why does their safety and soundness regulator feel compelled to reduce the capital requirements so quickly and so substantively before they even go into effect?
- Given the magnitude of the GSEs' exposure to mortgage risk, which is in excess of \$2.5T, why does OFHEO apparently feel more compelled to respond to private company competitive concerns than it does to protect the U.S. taxpayer from a catastrophic GSE failure?

Third, the Amendment appears to be an impulsive response to avoid “**unintended consequences.**” We have argued that these “unintended consequences” are unfounded in the case of private mortgage insurance, and we will present our arguments once again. Both the GSEs and the AA-rated mortgage insurers have an obvious financial interest in reducing or eliminating any differentiation between mortgage insurers based on financial

strength. Yet the GSEs have argued strenuously, when they wish to differentiate their securities from those rated AA, that there is a considerable difference between AAA and AA. In short, these are arguments of convenience adopted to address perceived flaws in the Final Rule rather than actual ones.

In terms of unintended consequences, we have come full circle. Fresh from the S&L debacle, Congress passed the 1992 Act to create meaningful risk-based capital standards to avoid a potential expensive and protracted bailout of the GSEs. Nearly a decade later, with the GSEs considerably larger in terms of size and importance, it is unclear whether the Final Rule imposes any additional capital discipline beyond the minimum capital obligations already imposed by the 1992 Act.

Indeed, it is highly questionable to assert that “adopting the Amendment will result in a capital requirement that corresponds more closely to capital levels that the marketplace would demand in the absence of benefits afforded the Government sponsorship of the Enterprises” without providing explicit confirmation of this statement. GE believes that the opposite will occur if the Amendment is adopted. Our reading of the Amendment suggests more favorable capital treatment for the GSEs and additional incentive for them to use less financially secure counterparties. This is directly contrary to Congressional intent, and clearly moves the GSEs further away from obtaining a true AAA rating without any government ties.

No AAA-rated company has a capital structure more leveraged than the GSEs, and the rating agencies explicitly note the importance of the special status given to the GSEs in maintaining an AAA rating. By approving these changes, OFHEO will ensure that the GSEs continue their dominant position in the domestic residential mortgage market by maintaining their extraordinary leverage. The real unintended consequence will be higher costs to the U.S. taxpayer in the event of a government bailout if either GSE fails.

Regulatory Process

The 1992 Act requires that “the regulations shall be sufficiently specific to permit an individual other than the Director to apply the [risk-based capital] test in the same manner as the Director.” Developing such a complex model in a highly competitive market with many vested business interests requires sustained attention to detail, as well as the ability to withstand political pressures.

We believe that OFHEO made every effort during the NPR2 process to assist those companies willing to invest significant resources on model replication. The model developed for NPR2 was extremely difficult to replicate, requiring hundreds of hours of effort and tens of thousands of dollars of expense. As a result, the field of informed comments on the rule was very small. Aside from the GSEs, perhaps only two entities attempted to replicate the model and understand the real drivers of the GSEs’ risk-based capital requirements. One was the GE-led MICA team, which was able to replicate and

validate portions of the OFHEO model by working closely with OFHEO's technical staff. We appreciate that assistance and OFHEO's willingness to accommodate us (and others) in extending the comment period twice in order to allow ample time for thoughtful, data driven analytical comments.

Now, however, the new model is even less transparent than the NPR2 model, despite OFHEO's attempt to improve the transparency of the Final Rule by making the model's source code available to all. Since the release of the source code this past summer, we have discovered that it contains "bugs" that made it unworkable. Despite receiving a new disk with "debugged" code, we have been unsuccessful in getting the model operational for use in analyzing the proposed changes to the Final Rule. Furthermore, it takes numerous software packages to start this model, at a significant expense. In addition, the lack of detailed installation instructions and OFHEO's very limited technical assistance have made it impossible to get the model operational. The 1992 Act that created OFHEO, in section 1361(f), requires the Director to make available copies of the capital model to the public for a reasonable fee. Simply put, source code is not a model, and this certainly is not any type of transparency.

Unfortunately, the entire process since release of the Final Rule has been opaque, trending toward weakening any risk-based capital requirements in excess of the GSEs' minimums. Although it appears that the GSEs are actively running the model and are in the final stages of validation testing with OFHEO, we have been told that we do not need a working model in order to make comments. While OFHEO has stated that, due to limited resources, it cannot provide dedicated technical resources to assist us in getting the model operational, other OFHEO staff members have indicated that OFHEO staff is providing precisely that type of assistance to the GSEs. Repeated attempts to have active dialogue with OFHEO's team have produced empty results. During a recent call with the OFHEO team concerning getting the model operational, many of our technical questions were not answered. We were repeatedly told to put such questions in writing. As a result, our comments on OFHEO's proposed improvements do not have the essential benefit of any model-driven analysis.

While we cannot verify the capital requirements, we believe that the amended Final Rule would not require the GSEs to carry substantially more capital than their minimum requirements. In fact, a Bear Stearns Equity Research report, entitled "OFHEO Rule Revisions Appear Beneficial for GSEs, MIs" and dated December 11, 2001, states, **"...the GSEs' risk-based capital requirements will be below their minimum capital requirements."** Given OFHEO's commitment to using conservative assumptions, we expected subsequent refinements to strengthen the baseline established by the Final Rule. Instead, every proposed change, but one, will weaken the capital requirements.

Rather than openly solicit input on relevant issues, OFHEO's communications have suggested more concern with satisfying market participants than with determining an appropriate level of capital to be held by the GSEs. In the case of mortgage insurers,

OFHEO should have been concerned with encouraging the AAA-rated GSEs to use equally secure counterparties instead of worrying about questionable market consequences such as “AAA concentration risk.” Are market consequences relevant to the GSEs’ safety and soundness regulator? Does OFHEO believe that it should determine the winners and losers in the U.S. mortgage insurance market?

Only OFHEO has the power to make such a sweeping determination in the “GSE world” of government charters and regulation; whereas, in the real, non-GSE world, the global capital markets recognize and price the AAA versus AA differential daily. Quoting from Treasury Secretary Paul O’Neil in the January 14, 2002 New York Times, “Companies come and go. It’s part of the genius of capitalism.”

The “battle” is not AAA versus AA. After all, AAA-rated GE Mortgage Insurance can, and may, release hundreds of millions of dollars of capital back to its parent and offer AA-rated mortgage insurance if OFHEO determines that there should be no economic incentive for the GSEs to use AAA-rated credit risk protection. In fact, the flight of capital may have already begun. The Bear Stearns December 11 Equity Research report, referred to above, states that the Amendment, “...is a positive for the AA-rated MI companies...it should reduce their need to continue hoarding capital.” Creating incentives to reduce industry capital is clearly not what Congress intended when it directed OFHEO to develop a capital rule in 1992.

While the Amendment substantially revises the Final Rule and provides only a 30-day comment period, institutions interested in analyzing the effect of the Amendment have not been provided with appropriate materials. Given the limited comment period during a time of extended holidays, and the difficulty and expense of obtaining materials from third parties (*i.e.* Moody’s Investors Service required a signed legal contract and \$5,000 fee to obtain access), our request for only a *two-week* extension was certainly reasonable and should have been granted. Instead, OFHEO turned it down.

Despite numerous calls and efforts to improvise, we received little help from OFHEO and no flexibility on the comment period. Others had similar experiences. We wonder why this final part of the rulemaking process needs to be so rushed in light of the importance and potential impact of the suggested changes. At a minimum, OFHEO should have quantified the impact of the proposed changes and provided a working copy of the model and sufficient time for analysis for those interested in providing substantive, analytical comments on the Amendment. Without those two gestures, this rulemaking carries overtones of a futile exercise where decisions, despite the request for comments, already have been made -- and are final. We believe that in order for OFHEO to act in a manner consistent with Congressional intent as expressed in the 1992 Act, and with its obligations under the Administrative Procedures Act and thus to the public, it should make effective the Final Rule and then follow a formal rulemaking process in suggesting “improvements” to the Final Rule.

Technical Revisions - Comments On The Proposed Amendment

As stated earlier, we strongly believe the Final Rule represents a more rigorous and appropriate risk-based capital treatment for the GSEs, and that it should be allowed to take effect before any changes are proposed. The Amendment will lead to lower GSE capital requirements relative to both the Final Rule and those carried by actual AAA-rated entities, and we therefore recommend it be rejected in favor of the treatment published in the Final Rule. However, given the uncertainty of OFHEO adopting this recommendation, we have made specific substantive comments to help truly improve the Final Rule.

There are two differing schools of thought regarding the appropriate phase-in period, five-year versus 10-year. We believe that a five-year phase in period is the more rigorous approach and offer our rationale and analysis as to why this would be most appropriate. If, however, OFHEO determines that its proposed 10-year phase-in period is appropriate, we believe that there is a better, more precise methodology to use when phasing in the haircuts over the 10-year period. In addition, we believe that we offer more precise criteria for determining effective counterparty defaults and sizing expected counterparty recoveries. In this section, we will also address OFHEO's proposed favorable treatment for unrated seller/servicers.

Counterparty Risk

The Final Rule gives the GSEs capital relief for payments received during the 10-year stress period from various counterparties, such as mortgage insurers and derivative counterparties. The objective of determining the appropriate haircuts is to properly account for the effect of counterparty failure during the 10-year stress period, since such counterparties are likely to be adversely affected by the stressful economic conditions with resulting defaults on some or all of their obligations. The stress test discounts, or "haircuts", the value of expected counterparty payments by a specified percentage each year, based on the public credit rating of such counterparty.

From April 2000, the date of its receipt of final comments on NPR2, to the issuance of the Final Rule in July 2001, OFHEO conducted a comprehensive evaluation of many conflicting comments on the NPR2 proposed haircuts. During this 15-month period, OFHEO also reviewed mixed commenter opinion on recoveries and chose to give recovery values zero credit. OFHEO further determined that the proposed haircuts should be phased in more quickly, shortening the phase-in period from 10 to five years.

In the Final Rule, OFHEO constructed its haircut tables based upon a review of both the Moody's 1920-1999 study of corporate bond defaults and the Hickman study, which OFHEO used to determine the two worst four-year cumulative default rates for investment grade corporate securities. These results, which indicated that cumulative

defaults roughly triple between AAA and AA categories, were used to determine the counterparty haircuts by rating category. The AAA haircut of 5 percent and the 15 percent AA haircut were established by OFHEO based on 1912-15 and 1932-35 default data and a comparison to historical averages.

GE agreed that this approach, using historic worst-case default data to determine the haircuts, was both empirically supported and most consistent with the purpose of the Act. We urged OFHEO not to succumb to political pressure and backtrack on its findings. Soon after release of the Final Rule, however, OFHEO announced that it would be willing to make changes to the Final Rule to address the criticisms of certain parties.

On July 23, only seven days after the Final Rule was issued, Fannie Mae and Freddie Mac met with OFHEO to lobby for changes to the Final Rule. Freddie Mac argued against the proposed haircuts as “too severe” and cited the “serious negative impact” created by the haircut differential between AAA and AA haircuts (In its on-the-record presentation, Freddie Mac not only used the familiar “low down payment loans will cost more” argument, but introduced the novel argument that the rule would create a “massive disruption in the MI industry”). Director Falcon, who was present at both meetings, apparently was persuaded and did not seek any comments from others who may have held different views. On July 30, 2001, the Wall Street Journal quoted him as saying that if Fannie or Freddie move to consolidate a great deal more risk among just the two AAA-rated mortgage insurance companies, “we would see that as unacceptable.” We will never know what level of “unacceptable” AAA concentration risk would have caused OFHEO to act. Instead of letting the efficient capital markets determine how entities with dissimilar ratings compete for business, OFHEO chose to significantly reduce the differential to the point where the GSEs would be indifferent in their selection of AAA and AA providers.

In the Amendment, OFHEO has proposed to alter its Final Rule haircut schedule for counterparty risk of default based on previously unavailable Moody’s default data. This new data contains annual default data for the worst three annual cohorts of U.S. investment-grade issuers since 1920, namely the cohorts formed at the beginning of 1929, 1930 and 1931. Using the average of these three cohorts, the cumulative 10-year default rate for AA-rated issuers (12.25 percent) was 2.6 times as large as the average default rate for AAA-rated issuers (4.72 percent).

Required to use a 10-year stress test, OFHEO therefore has focused its attention on determining worst-case probabilities of counterparty risk over the stress period. In setting its benchmark loss experience for loan loss development, OFHEO was constrained to use at least the two worst years of loss development. OFHEO complied by choosing years 1983 and 1984 for Oklahoma, Arkansas, Louisiana, and Mississippi. With the revelation that Moody’s could provide previously unavailable detailed corporate bond default information, OFHEO chose to use the *three* worst cohort years instead of *two*. The addition of a third year only serves to reduce the averages of the worst two. It

makes no sense to use three years in this particular situation. Not constrained by the 1992 Act to use at least the two worst years, OFHEO should have used an appropriately conservative approach and chosen the single worst *effective* cohort year.. All of the various options (worst three, worst two or worst one) involve the same companies. The only difference between the selections is that ratings for some companies went either up or down a notch.

We examined the three new cohort year data sets to determine which cohort year truly represents the worst counterparty exposure in the context of the OFHEO model. Counterparty risk should be measured in terms of not only the volume of benefits at risk, but at what point in the stress test do both the need for benefits and default risk arise. In other words, it should be measured in terms of effective counterparty risk. If the need for counterparty benefits is concentrated around year five, then the highest counterparty risk vis-à-vis the OFHEO model would be that cohort group which has the higher cumulative default rates at year five. Adoption of this approach would better measure the effective counterparty risk.

To estimate effective counterparty risk within the context of the OFHEO model, we cross-multiplied the cumulative default pattern of various cohort measures against the distribution of benefits expected. In Table 1 we list three different measures of cumulative investment grade default patterns: (1) actual year by year Moody's 1931 cohort; (2) actual average year by year of Moody's cohorts for 1930 and 1931; and (iii) the average of Moody's 1929-1931 cohorts as of the tenth year straight-lined from for years one through 10. Below these estimates of cumulative investment grade corporate default rates we show our estimates of OFHEO's distribution of losses under the down rate scenario.

Note that OFHEO's stress losses peak in year four, with the highest level of losses occurring in years three through five, (accounting for nearly 54 percent of all of the losses). In the bottom section of the table, we show the effects of multiplying the distribution of losses against the cumulative corporate defaults of the three different default groups. The highest percentage of missed benefits for all groups occurs in the 5th year. The summation of each of the ten years shows that, of the three approaches to estimating effective counterparty risk, the single cohort year of 1931 was indeed the highest, followed by the averages of 1930 and 1931, with the lowest being the straight-lined version of the 1929-1931 averages as proposed by OFHEO. According to Steve Liebling of Moody's, the 1931 cohort year has the highest five-year cumulative default rate of any cohort group since 1920.

**Table 1 . Effective Counterparty Risk As Determined By Investment Grade Cumulative Defaults
And The Distribution of OFHEO Model Loan Losses**

1931	1	2	3	4	5	6	7	8	9	10
Invmnt-Grade	0.48%	2.30%	8.78%	10.80%	13.83%	15.28%	16.79%	18.44%	19.00%	20.21%
Year By Year										
1930-1931	1	2	3	4	5	6	7	8	9	10
Invmnt-Grade	0.32%	1.53%	6.01%	10.22%	12.75%	15.14%	16.66%	18.28%	19.42%	20.41%
Year By Year										
1929-1931	1	2	3	4	5	6	7	8	9	10
Invmnt-Grade	2.03%	4.06%	6.09%	8.12%	10.16%	12.19%	14.22%	16.25%	18.28%	20.31%
Straight- Lined										

OFHEO Model	1	2	3	4	5	6	7	8	9	10
Loss Dist.	2.56%	4.49%	16.34%	19.57%	17.90%	14.54%	10.91%	7.34%	4.21%	2.13%

	1	2	3	4	5	6	7	8	9	10	Total Effective Discount
Effective Counterparty Discounts (Loss Distribution Times Corporate Default Rate)											
1931	0.01%	0.10%	1.43%	2.11%	2.48%	2.22%	1.83%	1.35%	0.80%	0.43%	12.8%
1930-1931	0.01%	0.07%	0.98%	2.00%	2.28%	2.20%	1.82%	1.34%	0.82%	0.44%	12.0%
1929-1931	0.05%	0.18%	1.00%	1.59%	1.82%	1.77%	1.55%	1.19%	0.77%	0.43%	10.4%

We recommend that OFHEO use the 1931 cohort year, using the actual pattern of defaults by year, to determine counterparty default rates. The use of actual year-to-year cumulative counterparty defaults more closely aligns counterparty risk to stressed losses versus OFHEO’s proposed straight-lined methodology. In addition, by adopting this approach OFHEO will establish a conservative regulatory methodology.

In Table 2, we show the average cumulative default rates by rating category by year for Moody’s single year cohort for 1931 and the averages for cohorts 1930 and 1931. We note that the 10th year default rates for both series are very similar to those proposed by OFHEO. However, we believe that the method of straight-lining each of the 10th year default rates by rating ignores the importance of true default development by rating category especially for the higher rated counterparties which OFHEO noted in the Amendment, but has so far decided to ignore.

Table 2 Highest Effective Counterparty Cumulative Default Rates

Moody's Worst Single Five Year Cohort - 1931

	1	2	3	4	5	6	7	8	9	10
Aaa	0.00%	0.00%	0.00%	0.00%	0.00%	2.00%	2.00%	2.00%	4.45%	4.45%
Aa	0.00%	1.32%	2.71%	3.82%	7.71%	8.55%	9.47%	10.94%	12.12%	12.12%
A	0.28%	2.08%	6.35%	7.06%	10.08%	11.39%	12.39%	15.25%	15.25%	15.25%
Baa	1.02%	3.45%	16.11%	20.12%	23.00%	24.96%	27.60%	28.86%	28.86%	32.77%

Moody's Averages of Two Worst Ten Year Cohorts (1930 and 1931)

	1	2	3	4	5	6	7	8	9	10
Aaa	0.00%	0.00%	0.00%	0.77%	0.77%	1.77%	2.73%	2.73%	3.96%	5.15%
Aa	0.00%	0.83%	2.07%	3.18%	5.71%	8.23%	9.15%	10.39%	11.79%	12.43%
A	0.14%	1.31%	4.95%	7.95%	10.00%	12.37%	13.52%	15.44%	16.81%	16.81%
Baa	0.72%	2.39%	10.47%	18.47%	21.81%	24.38%	26.78%	28.85%	29.53%	31.77%

Severity Rates

NPR2 handled counterparty default risk solely through the use of corporate bond default data. During the first comment period for NPR2, the GSEs proposed that OFHEO consider a recovery concept based on the premise that in the event of a default on a security, there is a market for defaulted bonds, albeit at a severe discount as suggested by defaulted bond bid prices. Furthermore, they argued that the presence of remaining premium income from failed mortgage insurance policies also should be considered, and suggested that OFHEO use defaulted bond recovery prices as a proxy for such recoveries as well.

GE agrees that it would be appropriate to use defaulted bond recovery rates to determine counterparty recoveries which reduce counterparty haircuts. However, GE also believes that OFHEO's estimate of a 30 percent recovery rate is based on a flawed rationale that fails to take into account all appropriate factors.

OFHEO appears to have based its estimate of recovery on the following information:

- 1) the W.B. Hickman study, which shows that for 1930-1943 average bond recovery bid prices averaged 34 percent (based on all defaulted bond issues);
- 2) Standard and Poor's data for 1981-1997, which show an average for all defaulted bond average bid prices of 44 percent;
- 3) Moody's data for 1981-2000, which show an average recovery rate of 39 percent;
- 4) A Moody's 1920-1996 study that shows that recovery rate estimates are substantially lower during recessions, and fall as low as 20 percent during the 1930s.

Without explaining precisely how OFHEO chose its 30 percent recovery number and with wide variances among the different data sets, there appears to be no compelling reason to adopt a 30 percent recovery rate, which would be applied to all non-derivative counterparties with investment grade ratings.

This rationale implies two unfounded assumptions: 1) that average recovery rates by investment grade bonds should have superior recovery rates compared to non-investment grade bonds, and 2) that there are no differences in defaulted bond recovery prices based upon industry classification.

First of all, GE believes that bid prices on defaulted bonds are not influenced by original rating or by ratings several years prior to default. OFHEO is not clear about whether the rating of the issue was important at origination or at some point several years prior to the default of the bond as an important factor in estimating a higher recovery bond value. Using original rating as this basis, Altman and Kishore concluded in their 1996 study of defaulted bond recovery rates for bonds defaulting between 1971 and 1995 that, after accounting for seniority status, there was little or no difference in recovery rates between investment grade and non-investment grade defaulted bonds. (See Table 3) Indeed, for many of the categories of seniority status, the average recovery values showed differences of less than two percent.

Table 3**Recovery Rates By Seniority and Original Bond Rating 1971-1995**

Seniority	Rating	# Obs.	Average Recovery Price
Senior Secured			
	Inv Grade	16	54.8
	Non-Inv Grade	58	56.4
Senior Unsecured			
	Inv Grade	49	48.2
	Non-Inv Grade	175	48.7
Senior Subordinated			
	Inv Grade	26	32.7
	Non-Inv Grade	136	39.9
Subordinated			
	Inv Grade	63	31.9
	Non-Inv Grade	136	31.7
Discount and Zero Coupon			
	Inv Grade	7	24.1
	Non-Inv Grade	30	24.4
Totals		696	41

Source: Altman, E., and Kishore, V. Financial Analysts Journal, Nov/Dec, 1996, "Almost Everything You Wanted To Know About Recoveries On Defaulted Bonds".

Secondly, GE has ample evidence that there is a substantial difference in defaulted bond recovery values between financial and non-financial companies. Altman and Kishore, in the same report cited above, segmented 696 observed issuer defaults by Standard Industrial Classification sector and by debt seniority. They found that the highest average recoveries between 1971 and 1995 were from the public utilities (70 percent) and chemical, petroleum, and related products (63 percent). Financial institutions fared below average at 35.7 percent, followed closely by construction and real estate at 35.2 percent. It appears that the differences observed are affected not only by the underlying

assets particular to a given industry, but also by the economic forces and conditions that prompted the defaults of companies.

Because the Altman-Kishore study considered average industry recovery rates only by all bond defaults and did not break out the separate industry data by year, GE obtained similarly detailed bond recovery prices from Moody's in an attempt to both update the Altman-Kishore study by industry and to include additional detail by year. The latest data taken from 1970-2000 comprise 1241 observations. While nearly doubling the size of the study, and with all of the additional data occurring during what might be viewed as the most prosperous portion of the 1991-2000 economic expansion, the new data set confirms Altman's earlier observations. (See table 4) While some overall industry averages remained unchanged, some, such as the financial sector, actually worsened -- primarily due to a greater number of subordinated bond defaults.

Table 4 Comparative Average Bond Recovery Prices By Industry

	1970-2000 Average Recovery Price	1971-1995 Altman Study Recovery Price
PUBLIC UTILITY	69.55	70.47
Senior	70.93	72.46
Subordinated	40.18	35.25
TRANSPORTATION	37.34	38.42
Senior	39.32	41.47
Subordinated	31.68	21.60
INDUSTRIAL	34.72	37.65
Senior	45.08	41.66
Subordinated	34.19	30.70
NON-FINANCIAL TOTAL	42.44	40.63
Senior	46.55	45.45
Subordinated	34.11	30.40
ALL FINANCIAL	29.50	35.69
Senior	38.36	37.87
Subordinated	20.63	24.81
All Defaulted Bonds	40.49	40.16
Senior	45.99	44.59
Subordinated	32.82	30.12

Given these differences in recovery prices by industry, differences in the mix of bonds outstanding by industry should produce different overall averages. We note that the average bond recovery values of institutions rated investment grade during the 1929-1939 period were strongly affected by the type of institutions rated during that period. According to Moody's: "As of 1920, more than half of the issuers Moody's rated were railroad companies, followed by utilities, industrials, and financial companies." According to Hickman, the distribution of rated issuers as of 1928 was railroads at 40.5 percent, utilities at 38.9 percent and industrials at 20.6 percent. Moody's admits that it rated very few financial institutions during the 1929-1939 period.

Currently, industrials make up 39 percent of rated firms, while non-bank financials are 17 percent and banking institutions 14 percent. It is most reasonable to conclude, therefore, that if today's mix of bond funding by industry were subject to the universe of 1929-1939, overall average recovery rates would have been substantially lower than as viewed by Hickman. Moreover, GSE counterparty recoveries, if available at all, should resemble recoveries on financial sector defaulted bonds that have proven historically to be lower than the market average.

In the Table 5, we show average defaulted bond recovery prices, as collected by Moody's, by three major industry classes along with the standard deviation of such prices over the period 1970-2000. The average bond recovery prices for all corporate issues for the period was 40.5 percent. Table 5 clearly shows the distinct differences in recovery rates by broad industry classification. Public utilities had the highest recovery rates at 69.6 percent, followed by non-financial sector bonds with 40 percent. Financial sector bonds experienced even worse results with an overall average of 29.5 percent for the entire 1970-2000 period, with half of its annual observations resulting in recovery rates of less than 30 percent.

For all corporate bond annual recovery rates there were eight years where recovery rates were below 30 percent (8 out of 31 observations). Six of these eight "below 30 percent" years occurred in the 1970s, a period in which five of the years were classified as years of economic recession. None of these recessions were anywhere close to the degree of economic stress present in the 1930s. Yet the average recovery rate for all bonds in the 1970s was only 27 percent, with all senior debt averaging 29.8 percent, and senior secured at 31 percent.

Table 5. Average And Standard Deviations Of Bond Recovery Values By Industry Sector By Year Of Default 1970-2000

		Financial	Non-Financial	Public Utility	All Issues
Year	1970	27.50	37.64		36.38
	1971		25.75		25.75
	1972		19.61		19.61
	1973		30.03		30.03
	1974		8.50		8.50
	1975		22.77		22.77
	1976		13.00		13.00
	1977		23.81		23.81
	1978		48.50		48.50
	1979		34.50		34.50
	1980		37.00		37.00
	1981		12.38		12.38
	1982		36.84		36.84
	1983		53.18		53.18
	1984		55.24		55.24
	1985	43.32	41.23		41.36
	1986		46.81		46.81
	1987	47.00	60.73		60.26
	1988	28.54	38.38	61.34	42.95
	1989	26.85	40.44		34.82
	1990	29.80	27.43	92.82	28.50
	1991	21.81	35.70	81.39	41.27
	1992	50.00	42.19	65.02	46.87
	1993	35.83	50.20	65.00	48.97
	1994		44.96	39.44	44.35
	1995	40.70	47.63		46.77
	1996		49.36	65.25	50.03
	1997	21.00	61.16		58.99
	1998	49.20	39.01		39.83
	1999	15.00	42.91	29.00	41.87
	2000	32.63	32.58		32.58

Averages All Issues	29.50	39.95	69.55	40.49
Standard Deviation	23.16	26.13	21.65	26.63

Avg Less 1 Std Dev 6.33 13.82 47.90 13.85

Therefore, if investment grade bond prices are no higher than non-investment grade defaulted bonds for a given seniority status, and all financial firms average recovery

prices have averaged 29.5 percent for the 1970-2000, with overall bonds at 27 percent for the 1970-1979 period, how does OFHEO justify a stress test recovery price of 30 percent for financial counterparties? And if 29.5 percent is the average of defaulted bond recovery bids on financial sector defaults for 1970-2000 how does OFHEO estimate an appropriate level for financial sector bonds under conditions as poor as they were during the 1930s to be consistent with the very high corporate default rates of that period?

In the absence of sufficient financial sector bond default experience from the 1930s, GE believes that an appropriate estimate can be found using the long-run average recovery price data for financial sector bond defaults and the long-run standard deviation. In our earlier comments on NPR2, we promoted the use of long-run 1920-2000 average corporate default rates and a multiple of the standard deviation of each rating category by elapsed year to achieve appropriate haircut levels by year for each of the individual years of the stress test. This approach yielded results that are very similar to OFHEO's current 10th year cumulative default rate estimates. These results were attained without the 1929-1931 individual cohort year data later made available by Moody's.

GE suggests that OFHEO use long-run average bond recovery values by seniority status within industry sector and the variance of such values to estimate worst case stress values for financial sector defaulted bond values. Near the bottom of Table 5, we also show the standard deviation of recovery prices by sector issues. Taking each average and subtracting one standard deviation provides an estimate of what is statistically referred to as the low end of values that could be consistent with expected values under average conditions consistent with the 1970-2000 period. To get an estimate of what might be considered statistically a "worst case" observation, one would need to move to an estimate consisting of the average less more than one standard deviation. (This compares to the GE approach on corporate default rates, which uses the long-run average default rate plus 2.5 standard deviations to achieve the same average 10-year cumulative defaults from the averages produced in the 1929-1931 Moody's cohort data.) The results clearly show that using long-run averages of financial sector defaulted bond prices less one standard deviation results in suggested stress condition financial bond recovery values of only 6.33 percent, and only 13.85 percent for all corporate bonds. If the 1970-2000 relationship between financial sector recovery values relative to all bond recovery values (29.5 percent / 40.5 percent) is applied to the stress estimate for all bond recovery values of 13.85 percent, one gets an estimated financial sector recovery value of 10.1 percent

GE believes that if one considers all of the relevant factors, OFHEO's estimate of a 30 percent recovery value is far too high relative to the type of stress envisioned in the Congressionally mandated stress test. We recommend that financial sector recovery values should equal 6 percent to reflect estimated worst-case experience. For all other non-financial counterparties a 14 percent recovery rate would apply.

Reduction of the Phase-In Period

Although we have just provided OFHEO our recommendations regarding counterparty defaults and recoveries for 10-year periods, we believe a more conservative approach would be to phase-in the estimated 10-year cumulative defaults on a straight-line basis over a five-year period.

On page 47804 of the Final Rule published in the Federal Register on September 13, 2001, OFHEO states, “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 OFHEO’s assessment that the phase-in period should be more closely aligned with the stress test conditions. Based on GE’s understanding of the stress test model, the three peak years of mortgage defaults occur in years three through five. Setting the phase-in period at five years would quicken the pace of counterparty defaults so as to more closely match the peak years of stressed mortgage defaults and the most likely real economic scenario. By conservatively establishing a five-year phase-in period, OFHEO will ensure that it does not over value the benefits of counterparties during the peak years of stressed losses.

We believe that the capital impact generated by the **combined** reduction in haircuts and the extension of phase-in period is particularly problematic because of the magnitude of these combined changes is not fully understood. OFHEO needs to more fully explain the interplay between the sizing of the haircuts and the phase-in period. This interplay can best be illustrated by the data and the analysis that follows. Over the past 32 months, OFHEO has proposed three sets of haircut and phase-in periods, as follows:

	April 1999 NPR2	Sept 2001 Final Rule	Dec 2001 Proposed Amendment
AAA	10%	5%	3.5%
AA	20%	15%	8.75%
A	40%	20%	14.0%
BBB	80%	40%	25.0%
Phase-In	10 years	5 years	10 years

We believe that to best see the impact of the proposed changes one should look at year five of the 10-year stress period, where mortgage defaults are at their peak. Examining

these “effective” haircuts by taking into account that the haircuts are phased in on a monthly basis over the phase-in period, the effective year-five average haircuts would be as follows:

	Effective Year-Five Average Haircuts		
	April 1999 NPR2	Sept 2001 Final Rule	Dec 2001 Proposed Amendment
AAA	4.5%	4.5%	1.575%
AA	9.0%	13.5%	3.9375%
A	18%	18%	6.3%
BBB	36%	36%	12.6%

The magnitude of the December proposed changes is enormous, especially considering the nine-year history leading up the change.

After seven years of painstaking development, OFHEO issued the proposed haircuts and phase-in periods in NPR2. Over the next two plus years of detailed review and analysis of hundreds of pages of comments and careful deliberation and evaluation of different data and methodologies, OFHEO amended the rule. Although it made significant changes to many parts of the rule, OFHEO only made minor modifications to the “effective” haircuts (i.e. the halving of haircuts was mostly offset by the halving of the phase-in period). To quote from the Final Rule, page 47804 in the Federal Register, “OFHEO considered a number of alternatives to the haircuts in the final rule. 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.” Now, within three months of publishing the Final Rule, OFHEO is proposing to effectively increase the benefits the GSEs get from third parties a staggering 71 percent for AA non-derivative counterparties and 65 percent for all other non-derivative counterparties. How could changes of this magnitude be warranted? How could OFHEO have missed so badly on its first two attempts?

OFHEO’s separate discussions of the nominal haircuts and the phase-in periods would lead one to believe that these changes are immaterial. However, when combined, they result in a capital windfall to the GSEs that only OFHEO can calculate with any degree of certainty. **Our estimates indicate that the proposed revisions to the GSEs' derivative and non-derivative counterparty haircuts when combined with the extension of the phase-in period to 10 years results in a reduction of over \$4B of capital for the GSEs.** By not publishing the capital impact numbers, OFHEO prevents the public and Congress from having the most essential information about the impact of the proposed changes--- the quantitative reduction in required capital that they will allow.

OFHEO has stated in the Final Rule that OFHEO’s use of haircuts to reflect losses due to counterparty failure is similar to the methodology of the rating agencies. However, a

review of how Standard & Poor's ("S&P") and Moody's haircuts the reinsurance benefits that a AAA mortgage insurance provider gets from lesser rated insurance providers indicates that OFHEO's phase-in period is not nearly as conservative as the rating agency-deployed methodologies. The rating agencies' assessment of the benefits obtained by a AAA-rated financial guarantor (like the GSEs) from insurance and bank counterparties is shown in the following table:

Financial Strength or Credit Rating	Moody's Assessment of Reinsurance or Financial Benefit Received	Standard & Poor's Assessment of Reinsurance Benefit Received
AAA	100%	100%
AA	80-90%	75%
A	40-60%	50%
BBB	0%	0%

The rating agency approach would impose these haircuts immediately. Under the OFHEO haircut methodology, the discount ramps up from zero on day one to the proposed haircut percentage in the last month of the 10-year stress period. As a result, the effective OFHEO discount is less than the one stated, since the bulk of the losses and counterparty payments received occur within the first five years. The maximum discount does not occur until the tenth year, so the haircuts are not nearly as severe as the rating agency discounts.

S&P has for several years utilized a 10-year cash flow stress test capital model as part of its process of determining mortgage insurance ratings. This model is based on the severe loss development experienced in the west south central region of the United States of the early 1980s, thereby greatly mirroring the OFHEO stress test.

In reviewing the capital adequacy of each MI company relative to specific ratings, S&P utilizes a single stress test. In the S&P framework, total sources of funds (capital, net premiums earned, interest income) are compared to total uses of funds (losses, expenses, taxes). The resulting ratio of sources to uses serves as a measure of capital adequacy and drives the resulting four rating categories as follows:

<u>Rating Category</u>	<u>Minimum Sources / Uses</u>
AAA	100 %
AA+	92.5 %
AA	82.5 %
AA-	75.0 %

Assuming each company starts the stress with minimum capital necessary to achieve minimum sources/uses ratios for their respective ratings, and that each company has an identical book of business, the AA-minus company runs out of capital after the 4th year of

the S&P stress; AA companies run out of capital after the 5th year; and AA+ companies run out of capital after the 6th year. Prior to such exhaustion of capital, state insurance regulators would intervene and halt further full claims payments until such time as all potential future claims could be determined. Consequently, effective company defaults would occur at points in time earlier than when total capital would be exhausted.

GE cannot determine at this time the degree to which the OFHEO model differs from the S&P stress test. But because OFHEO's stress losses follow a path of losses similar to that of the S&P test, the effective default rates on counterparties should reflect similar timing. Therefore, GE firmly believes that OFHEO got the phase-in period right for counterparty risk. Less than AAA rated counterparties engaged primarily in mortgage credit risk are more likely to default earlier in the 10-year stress period, but at levels no higher than the ultimate 10-year default rates of other similarly rated companies.

Thus we strongly urge OFHEO to return to utilization of a five-year phase-in period. We believe this approach more closely ties capital to risk, would reduce the huge effective haircut reductions proposed in the Amendment and still would not be as onerous as the methodologies deployed by the Rating Agencies when evaluating similar relationships.

Unrated Seller/Service Providers

GE remains strongly opposed to unrated seller/service providers being afforded the same rating status as a BBB-rated counterparty. Such treatment is totally inconsistent with all historical default data on below investment grade corporate defaults and with the statutory mandate to utilize characteristics "most consistent with the stress period." There is no empirical data supporting OFHEO's BBB treatment of unrated seller/service providers. Although this proposal has been in place since NPR2, the magnitude of this treatment has been materially magnified under the proposed Amendment.

Under NPR2, these unrated seller/service providers were given an 80% haircut phased in over 10 years. Under the proposed Amendment, these same unrated companies would be given only a 28 percent haircut phased in over the same 10-year period. That is an astounding 52 percentage-point improvement, or a 65 percent improvement in the treatment of unrated seller/service providers, who are typically small, highly leveraged mortgage bankers. Allowing these unrated, thinly capitalized businesses the same status as BBB companies that have subjected their businesses to the critical scrutiny of independent rating agencies is clearly an inappropriate and totally unsupported action by OFHEO and is inconsistent with OFHEO's primary safety and soundness goals as outlined by Congress. Such treatment also is inconsistent with OFHEO's stated objective that a "conservative evaluation of risk is appropriate for regulatory purposes."

In its latest proposal, however, OFHEO takes unrated seller/service providers to even higher levels of financial strength, giving such entities up to AA equivalent ratings if they meet certain criteria. These criteria include having been given "delegated underwriting and

servicing authority” by the GSEs plus entering into “loss-sharing obligations with fully funded reserve accounts” pledged to the GSEs.” OFHEO is proposing to amend the Final Rule to permit a rating higher than BBB for these seller/servicers if the fully funded reserve account is equal to or greater than an amount determined by OFHEO. OFHEO gave an example of such a reserve account equaling just one percent of the seller/servicer’s aggregate unpaid principal balance covered by such agreements.

OFHEO also states “the rating of the issuer of the instrument backing the reserve account may be used, in lieu of BBB, as the rating of the unrated seller/servicer, except that in no event will the rating exceed AA.”

This treatment incorporates several more errors and inconsistencies. It contemplates that the reserve fund need not be fully funded, and that the reserve could be supported by a partial letter of credit or some other form of partial guaranty by a third party. Should the third party carry a rating higher than BBB, OFHEO may allow the effective counterparty rating of the seller/servicer to be raised to the same as that of the guaranty provider. Why should the pledging of collateral change the rating of the seller/servicer at all? Derivative counterparties pledge collateral and do not get the benefit from lower default rates and corresponding higher ratings; they only get higher recovery values upon default.

OFHEO uses the Fannie Mae DUS program as an example. As GE understands the program, the DUS seller/servicer is required to maintain a reserve fund of at least one percent against the outstanding balance of loans covered by the loss sharing agreement. The seller/servicer must first pay its obligations out of its own funds or forfeit the entire reserve fund to Fannie Mae, who then can rely on the reserve to pay the next one percent of losses. While loss of such a reserve is a tremendous incentive to continue to pay losses, most seller/servicers do not have much in the way of liquid assets in a period of economic stress other than their servicing rights. If their GSE portfolio is performing poorly (e.g. high delinquencies and losses) and thereby requires loss-sharing payments, the value of such servicing rights will naturally be sharply reduced.

The majority of GSE-approved seller/servicers are not rated, primarily because they do not have sufficient capital to weather periods of economic stress. This can be verified by examining the turnover in the GSEs’ own customer base over the last ten years. OFHEO is suggesting that seller/servicers that have little in the way of hard capital beyond the value of their servicing rights, if any, can achieve a AA equivalent rating by simply either funding a reserve fund or purchasing a partial letter of credit in an amount equal to one percent of their recourse obligations. This implies that such companies would be considered the equal of companies that carry substantially greater amounts of capital relative to risk and undergo rigorous scrutiny by regulators and rating agencies to determine their status as superior credit risks. If this approach is allowed for seller/servicers, OFHEO should allow unrated mortgage insurers an AA equivalent rating if the insurers used the GSEs automated underwriting systems and set up a

one percent reserve fund? OFHEO should check with the rating agencies to see if this approach is reasonable; we do not believe that it is.

OFHEO's proposal, by incenting the GSEs to accept such structures not only for DUS programs, but for all other forms of risk protection, represents an enormous threat to the safety and soundness of the entire mortgage system. This structures and arrangement that the Amendment incents could displace the mortgage insurance industry, since seller/servicer recourse is an acceptable form of credit enhancement on high LTV loans according to the GSE Charter Act. Freddie Mac already has expressed its concerns for a stable mortgage insurance industry in its July 23, 2001 presentation to OFHEO (i.e. their concern was that the Final Rule's AAA versus AA haircut differential would create a "massive disruption of MI industry.") How could this proposed amendment not be considered disruptive?

OFHEO's professed goal of incorporating a ratings-based approach for assessing counterparty credit risk is at odds with its support of institutions whose primary function is loan origination and servicing, not financial guaranty? If OFHEO does not rescind this particular proposal, will large A-rated or BBB-rated originators be able to set up such structures and then pressure the GSEs and OFHEO to accept their self-insured recourse with the reserve account as the equivalent of a AA rating? If so, then OFHEO will, through unintended regulatory actions, decide who the winners and losers will be in the U.S. residential mortgage market.

GE recommends that any funds in the reserve account invested in Treasury securities with maturities of one year or less should be given a zero haircut. For securities with maturities greater than one year, a 30 percent discount should apply. This is consistent with the Final Rule. Any remaining un-collateralized counterparty obligation should get a haircut based upon such counterparties actual rating.

Tying Capital Benefits to Use of GSE-owned AU Systems

Our concerns with this proposed treatment of unrated seller/servicers also extend to the requirement that such seller/servicers must be approved for delegated underwriting and servicing by the GSEs in order to get this preferential treatment. We have two main concerns with the requirement that a seller/servicer must use the GSE's proprietary automated underwriting system, either DU or LP, in order to get delegated underwriting status.

First, it will incent the GSEs to grant more delegated underwriting status to their seller/servicers and encourage loss-sharing arrangements with such entities in order to benefit from a lower haircut. Does OFHEO believe that having more delegated underwriters is better for the GSEs from a risk management perspective? Does OFHEO want to encourage more loss sharing with unrated seller/servicers? In developing its risk

based capital model, OFHEO has given no value to credit scoring or mortgage scoring until now.

Second, the GSEs earn increasingly large user fees from their AU systems. OFHEO will now make it more compelling to seller/servicers to purchase LP and DU capabilities in order to potentially get lower haircuts. This is similar to Microsoft 's bundling of products and services, a practice determined to be anti-competitive. Bundling LP and DU requirements to lower haircuts would make all competing industry automated underwriting systems, some of which are demonstrably superior to the GSE-owned systems in predicting the default risk of residential loans, totally uncompetitive. This “improvement” to the Final Rule would surely lock in the GSEs already dominant share of the U.S. automated underwriting market. OFHEO’s actions will inappropriately pick the winners and losers in the automated underwriting market.

Unintended Consequences - Separating Fact From Fiction

There are three areas that we would like to quickly cover in this section of our comment letter. They are summarized as follows:

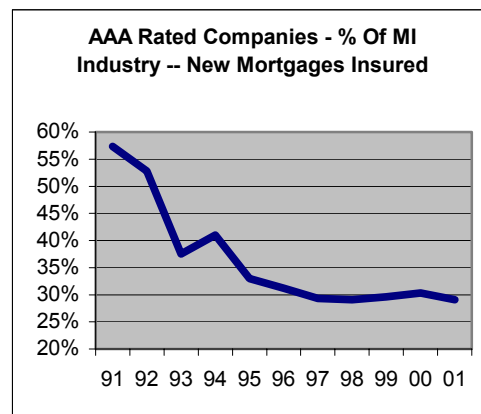
- Would the Final Rule truly create an AAA concentration risk for the GSEs?
- Does Fannie Mae really believe that AAA-rated and AA-rated counterparties or securities are truly equal?
- What did OFHEO mean by its statement, made in the Amendment's section on Default Rates, that, “An excessive differential between these ratings [AAA versus AA] in the stress test could create inappropriate business incentives for the Enterprises.”

AAA Concentration Risk

As a safety and soundness regulator, OFHEO’s decision to alter its haircut methodology in order to narrow the differences in effective counterparty discounts of AAA and AA companies leaves GE baffled. One of the primary differences in S&P’s minimum rating criteria for individual rating levels is the adequacy of capital relative to risk exposure in its 10-year stress test. The minimum capital required of a AAA company is nearly double that of a AA-minus company and 50 percent higher than a AA company. We simply do not understand why a safety and soundness regulator would manipulate its counterparty risk measures to a degree that leaves the GSEs financially indifferent to AAA or AA counterparty risks. Why would a regulatory incentive to use AAA companies be considered an “inappropriate business incentive?”

In 1991, AAA-rated MI companies accounted for 57 percent of MI insured mortgages outstanding. By mid-2001, the AAA share declined to 29 percent. The following chart depicts the decline of AAA mortgage insurance over the last 11 years. Following the

1990-1991 recession, the US economy experienced a very steady expansion, punctuated by low unemployment rates and steady home price appreciation. Market optimism demanded less security. Leading the incredible expansion of the mortgage market over this period were the two GSEs. “Conforming” loan eligibility more than kept pace with market growth, squeezing prime loan non-conforming private MBS formation, which in part relied on higher rated insurers for supplementary and pool policies. Neither Fannie Mae nor Freddie Mac had any incentive to value AAA over AA. Their securities were considered as AAA due to implied government support. As a result, one MI company elected to cancel its AAA-securing reinsurance. No AA company sought to upgrade its rating beyond the AA range. The required additional capital or expense of outside reinsurance would only serve to lower returns on capital.



Statements that higher differentials in AAA versus AA counterparty haircuts would cause a disruption in the market by increasing AAA concentration within the GSEs are overstated. Today, GE and United Guaranty, the only two AAA mortgage insurance companies, have a combined market share of approximately 30 percent. If both companies were to immediately increase their new business written to 28 percent each, a combined 56 percent, it would take approximately five years for each company to reach an average 23.5 percent of insurance in force. Thus, at the end of 2006, GE and UG would have a combined insurance in force market share of 57 percent, which equals the combined market share of GE and AA-rated MGIC in 1993. Neither the GSEs nor OFHEO raised “concentration concerns” in 1993.

The following chart shows the historic and projected insurance in force of the top five mortgage insurance companies, assuming the above highly optimistic market share gains of the two AAA MI companies. Over the course of those five years, the AA companies would likely find ways to compete as they always have in the non-conforming market. Alternatively, some AA companies could choose to seek a AAA-rating through additional capital and/or reinsurance arrangements. GE believes that should the Final

Rule haircuts and phase-in period remain unchanged, at least one and possibly three AA MI companies would seek to become AAA. We believe this would be an appropriate business incentive for the U.S. mortgage market.

Share Of Insurance In Force

	<u>1993</u>	<u>1997</u>	<u>2000</u>	<u>2006</u>
GE	31%	24%	18%	24%
UG	12%	13%	14%	23%
MGIC	26%	26%	25%	21%
PMI	17%	14%	16%	13%
Radian	6%	12%	15%	11%
Top 3	74%	64%	59%	68%

Fannie Mae Views On AAA versus AA

The following is a brief comparison of the comments offered by Fannie Mae in its response to two risk-based capital rules: (1) OFHEO’s Notice of Proposed Rulemaking on Risk-Based Capital (April 14, 2000) (“OFHEO Comment”) and (2) the Federal Financial Institutions Examination Committee’s “Proposal to Revise the Risk-Based Capital Treatment of Recourse and Direct Credit Substitutes” (June 7, 2000) (“FFIEC Comment”).

The different positions taken by Fannie Mae in these two rulemaking proceedings seem contradictory, driven perhaps by whether Fannie Mae would directly benefit from a particular position. GE has maintained a consistent, data driven, conservative approach in its regulatory comments. We urge OFHEO to filter out self-servicing comments and thoughtfully consider those comments backed by data or established industry approaches.

Fannie Mae’s inconsistencies are three-fold.

First, at the top of the credit rating scale, Fannie Mae offers different assessments of the importance of the relative strength of AAA-rated versus AA-rated obligations. In its OFHEO Comment, Fannie Mae argued for minimal differences between AAA-rated and AA-rated counterparties, proposing a three percent haircut for AAA counterparties and a four percent haircut for AA counterparties. However, in its FFIEC Comment, Fannie

Mae argued “it is clear that AAA ratings are superior to AA and corporate guarantees preferred to security structures,” presumably since the risk weighting of assets guaranteed by a AAA-rated entity would be a point of competitive differentiation for Fannie Mae. (Compare OFHEO Comment at 171-172 with FFIEC Comment at 5-6).

Second, Fannie Mae offers different assessments of the relative security of non-rated and BB and lesser-rated obligations. In its OFHEO Comment, Fannie Mae carried its argument regarding minimal differences between counterparties down the credit rating scale, with a 12 percent maximum haircut proposed for BBB-rated and non-rated counterparties. However, in its FFIEC Comment, Fannie Mae made two different arguments. First, Fannie Mae argued that securities with long-duration collateral (like fixed-rated mortgages and manufactured housing) are riskier (i.e. have more interest rate risk) than securities with short-duration collateral (like credit card receivables), urging the regulators to consider differentiating risk weights based on the duration of the underlying collateral. Second, Fannie Mae argued for a sharp increase in default probabilities below BBB, stating that the average default experience for a BB-rated entity is over eight times that of a BBB entity. (Compare OFHEO Comment at p. 6 with FFIEC Comments at pp. 5-6, 9 and 17). So, with its 12 percent haircut for BBB and unrated counterparties in mind for the OFHEO stress test, Fannie Mae stated to FFIEC that “[u]nder a stressful economic environment scenario, it is quite likely that both the BB and BBB positions would suffer a complete loss.” (FFIEC Comment at p. 9). The historical data clearly supports the position that lower ratings reflect greater probabilities of default, yet Fannie Mae’s two positions appear to be completely contradictory.

Third, Fannie Mae offers different assessments of the appropriate regulatory approach toward split ratings and use of internal models. In its OFHEO Comment, Fannie Mae argued for recognition of its internal risk assessment when only one or no rating is available, with a minimum rating/haircut of BBB in all instances. Regarding split ratings, Fannie Mae stated to OFHEO, “when two or more ratings from the agencies are available, then the appropriate ratings should be the median value”. However, in its FFIEC Comment, Fannie Mae vigorously criticized the use of internal ratings, suggested no minimum rating/haircut and recommended requiring at least two ratings (with limited exceptions) and using the lesser rating in the case of split ratings. The difference? Apparently, the combination of Fannie Mae’s “business practices” and “OFHEO examiner oversight” reduces the problem of moral hazard relating to the use of internal models to an acceptable level, but similar business practices of other federally regulated financial institutions, and the competence of their examiners, require additional regulatory backstops in order to reduce the possibility of moral hazard. (Compare OFHEO Comment at 172 and 184-185 with FFIEC Comment at pp. 2-3, 18).

Inappropriate Business Incentives

We are very troubled by OFHEO’s statement in the Amendment regarding the relationship between AAA and AA haircuts. OFHEO states, “An excessive differential

between these ratings in the stress test could create inappropriate business incentives for the Enterprises.” We strongly urge OFHEO to clarify what its concerns are and discuss why these concerns are appropriate for a safety and soundness to address. Our concerns are as follows:

If industry concerns are appropriate for a safety and soundness regulator, we believe OFHEO should be concerned that the risk-based capital rule creates inappropriate incentives *not* to use the highest quality counterparties. If the goal of the Amendment was to make the GSEs indifferent as to their choice of AAA and AA risk partners, OFHEO appears to have succeeded. In fact, *Inside Mortgage Finance* reported in its December 14 issue, only three days after OFHEO released the Amendment, “...that Freddie Mac officials have indicated the differential [between AAA and AA] is now small enough to overlook,” while Banc of America Securities, in an Equity Research piece on the mortgage insurance industry dated December 11, states, “...it seems clear that a triple-A rating most likely would be unnecessary and very costly in terms of shareholder returns.”

Is it really OFEHO's intent to have a model based on a rating agency approach but with no meaningful differential between AAA and AA?

Our concern is simple. Should Fannie Mae and Freddie Mac, with combined risk of over \$2.5 trillion, be *incented* or *indifferent* when seeking the highest quality risk protection?

In conclusion, we strongly believe that the GSEs should be incented to seek the strongest risk partners. OFHEO can re-establish an appropriate incentive by adopting GE’s four recommended proposals:

- 1. Use the worst *effective* annual cohort year to determine the default rates by rated counterparty.**
- 2. Reduce the recovery rate for financial institutions from 30 percent to 6 percent to reflect the poorer actual experience of such institutions and to 14 percent for non-financial sector securities.**
- 3. Shorten the phase-in period for investment-grade derivative and non-derivative counterparties and securities to five years to more closely tie capital to risk, soften the huge effective haircut reductions proposed in the Amendment and better align OFHEO’s approach to rating agency discounts applied to AAA insurers.**
- 4. Do not permit unrated seller/servicers to achieve a higher rating than the already generous BBB rating, based upon their participating in GSE loss-sharing arrangements and funding of reserve accounts.**

Today, AAA credit enhancement is appropriately recognized in non-GSE transactions, thereby justifying the increased capital held by AAA companies. This will not be the case if OFHEO’s proposal is passed. If these changes were implemented, GE and others

would have to seriously consider discontinuing providing AAA mortgage insurance for its GSE business and move to an AA standard. Why would a safety and soundness regulator precipitate such action and create a corresponding flight of capital from the industry?

We believe that withdrawing the Amendment would be the most appropriate course of action at this time. There is no need to rush proposed changes through the system before the Final Rule has become effective and the GSEs comply with their new risk-based capital requirements. At a minimum, OFHEO should adopt our proposals, which would help maintain the discipline and rigor that the Final Rule promulgated as well as maintain public confidence in the financial integrity and the stability of the secondary mortgage market. Due to the enormous size and importance of the GSEs and the potential catastrophic consequences of underestimating capital, it would be more responsible to err on the side of holding more capital than less.

We thank you for the opportunity to comment on this very important rule and look forward to maintaining active dialogue with you as OFHEO continues to seek to perform its important mission.

Sincerely yours,

James C. Zollo
Managing Director – Capital Markets

Gerhard A. Miller
Senior Vice President
General Counsel