Federal Home Loan Bank of Chicago
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VIA FEDERAL EXPRESS

Office of the Controller
of the Currency
Attn.: Docket No. 00-06
Communications Division
Third Floor
250 E Street, S.W.
Washington, D.C. 20219

Board of Governors of the
Federal Reserve System
Attn.: Ms. Jennifer J. Johnson,
Secretary, [Docket
No. R-1055]
20th Street & Constitution
Avenue, N.W.
Washington, D.C. 20551

Federal Deposit Insurance
Corporation
Mr. Robert E. Feldman
Executive Secretary
Attn.: Comments/OES
550 17th Street, N.W.
Washington, D.C. 20429

Office of Thrift Supervision
Manager, Dissemination Branch
Records Management &
Information Policy
Attn.: Docket No. 2000-15
1700 G Street, N.W.
Washington, D.C. 20552

Re: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

## I. INTRODUCTION

The Federal Home Loan Bank of Chicago ("Bank") is pleased to submit our comment on the Joint Notice of Proposed Rulemaking published in the March 8, 2000 Federal Register by the Office of the Controller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively the "Agencies") regarding risk-based capital standards - recourse and direct credit substitutes ("Proposal"). The Bank's comment focuses on how the Proposal would impact the risk-based capital requirements of its member financial institutions and the competitive position of financial institutions in home mortgage finance.

## II. BACKGROUND ON THE BANK

The Bank is a $30 billion wholesale financial institution with a mission to promote sound and economical home finance, chartered by Congress, and privately owned by member financial institutions. The Bank, rated AAA by Standard & Poor's and Aaa by Moody's, provides a source of reliable, economical credit to over 800 member commercial banks, savings institutions, credit unions and insurance companies in Illinois and Wisconsin, offering floating and fixed rate loans called advances, the Mortgage Partnership Finance® Program and related products to finance home mortgage portfolios. The Bank and the other eleven Federal Home Loan Banks, which comprise the $583 billion Federal Home Loan Bank System, are regulated by the Federal Housing Finance Board ("FHFB"), an independent agency of the Federal government.

In 1997, the Bank introduced the Mortgage Partnership Finance® Program ("MPF®") as a pilot program to give members of the Bank a new financing alternative for one-to-four family residential mortgage loans. The MPF® Program optimally allocates the component risks between the member institution and the Bank.

Since 1997, the MPF® Program has achieved great success and acceptance in the mortgage market. Now proposed by the FHFB to be a permanent program, the MPF® Program has expanded to ten of the twelve Federal Home Loan Banks. As of April 30, 2000, nationwide there are $5.2 billion in outstanding loans, representing 188% of growth since December 31, 1999, and 119 member financial institutions participating in the Program. There is broad income distribution among homebuyers benefiting from the MPF® Program. Sixty-eight percent of the loans funded to date have been to low and moderate income families. To date, no credit losses have been experienced. This program is discussed in more detail in Section IV., below.

## III. COMMENT ON PROPOSED RULE - IN GENERAL

First, we address the overall philosophy and methodology contained in the Proposal. We note that the Proposal continues to impose on insured financial institutions more onerous capital requirements in home mortgage financing transactions, thus disadvantaging such institutions competitively in favor of other market participants able to engage in the same transactions with less capital and less economic cost. The Proposal systematically

favors the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), mortgage bankers and private mortgage insurance companies ("MI") for mortgage transactions at the expense of financial institutions. To the extent consistent with safety and soundness, the Agencies should not competitively disadvantage the institutions they are chartered to supervise.

The market has firmly established the level of capital necessary for residential mortgage credit risk, as distinguished from interest rate risk. The Proposal would continue to require excessive capital and thereby penalize financial institutions as competitors in this essential mortgage credit risk market. Fannie Mae and Freddie Mac have a statutory 0.45% capital requirement for a first loss credit risk position on their off-balance sheet guarantees of over $1 trillion of outstanding mortgage-backed securities. This is a direct credit substitute in first loss position and is the dominant factor in the mortgage market. With this capital requirement, both Fannie Mae and Freddie Mac are rated AAA/Aaa by Standard & Poor's and Moody's and AA on a "risk to the government" basis. The Proposal should insure that capital requirements for mortgage credit risk are consistent with this clear market standard.

In addition, the private, state-regulated MI's, which are purely in the mortgage credit business, are required to hold approximately 4% of the face amount of first loss coverage in the mortgage insurance business. Thus, MI companies effectively hold 0.80% of capital coverage of the mortgage loan if one applies a 4% capital requirement against the 20% first loss, direct credit substitute position they typically hold. The loans insured are typically high loan-to-value loans. With these capital requirements, the credit ratings of the principal MI companies is shown in Table I.

TABLE I

| Name | Rating |
| --- | --- |
| GE Capital Mortgage Insurance Co. | AAA |
| Mortgage Guaranty Insurance Co. | AA+ |
| PMI Mortgage Insurance Co. | AA+ |
| Radian | AA |
| Republic Mortgage Ins. Co. | AA |
| Triad Guaranty Ins. Corp. | AA |
| United Guaranty Corp. | AAA |

Source: Standard & Poors, February, 2000

These capital standards, which result in AA or better ratings for the MI's, are far below the capital which would be required for mortgage credit risk by the Proposal. If private creditors are willing to put their funds at stake in companies that are exposed to mortgage credit risk with these capital levels and receive AA ratings, that suggests that those same levels will provide the appropriate cushion for loss for insured financial institutions engaged in the same business.

As a further market standard, GE Capital Mortgage Insurance Company has capital equal to 1.1% of the outstanding principal of mortgage loans it insures and is rated AAA. A mortgage insurance policy is a pure direct credit substitute representing a very large and sophisticated market. The Proposal should be consistent with this market in its treatment of mortgage credit.

The Proposal would encourage the effective transfer of a responsibility of the Federal government, the determination of regulatory capital, to private, for-profit rating agencies. Rating a security is a different responsibility from determining financial institution capital. The proposed transfer of government responsibility to private, for-profit rating agencies would create an irreconcilable conflict of interest. It would, in effect, make the rating agency a regulator. These agencies are private, for-profit entities which will be seeking business from the very entities affected by their rating decisions on their customer's capital. Thus, the Bank recommends that private

ratings not be mandated for the determination of risk-based capital but rather be allowed as one permitted alternative in the determination of an institution's capital.

The Proposal does not recognize the fundamental differences in component risks of residential mortgage loans as compared with other asset classes. Most of the capital for holding residential mortgage loans is required for interest rate risk, rather than credit risk. The Proposal penalizes mortgage transactions by requiring capital substantially in excess of the actual credit risk, as measured by vast, statistically available data on loss experience. The superior performance of one-to-four family residential mortgage loans covering trillions of dollars of loans, as an asset class, is well known. For example, Table II shows the very low loss rates of 1-4 family mortgages relative to other loan classes.

Table II

LARGE BANK AGGREGATE GROSS CHARGEOFF DATA

| | 7 Year Average |
|---|---|
| Foreign Governments | 7.47% |
| Credit Card | 4.23% |
| Construction and Development | 2.47% |
| Real Estate Secured | 1.57% |
| Other Consumer | 1.49% |
| 5+ Family | 1.48% |
| Commercial & Industrial | 1.11% |
| Agricultural | 0.97% |
| Lease Financing Receivables | 0.63% |
| Farmland | 0.61% |
| Depository Institutions | 0.44% |
| 1-4 Family Mortgages | 0.25% |

Source: Standard & Poor's

Even lower annual loss rates are demonstrated by the mortgage loans of banks and thrifts -- often .03% or less -- and by Fannie Mae with a 5 year average of .04%, and Freddie Mac with .07%.

## IV. EFFECT OF PROPOSED RULE ON THE MORTGAGE PARTNERSHIP FINANCE® PROGRAM

### A. Summary of Mortgage Partnership Finance® Program

#### 1. Background and Description

The MPF® Program contains a variety of products developed by the Bank, which benefit both financial institutions and home buyers.

A financial institution making a residential mortgage in the market previously had only two choices:

(a) It could hold the loan in portfolio, incurring significant interest rate risk; or

(b) It could sell the loan for securitization, principally to Fannie Mae or Freddie Mac.

Holding the loan in portfolio requires that the institution retain the interest rate risk involved in long term mortgages. In addition, regulatory risk-based capital requirements discourage portfolio lending: a financial institution must hold more than twice as much capital against a whole loan as it does against an agency mortgage-backed security.

Therefore, financial institutions tend to increasingly sell loans they originate into the secondary market, for which they pay a guaranty fee to Fannie Mae or Freddie Mac. In fact, more than half of all outstanding mortgage loans are now securitized.

The Bank has created a third strategic alternative to holding loans in portfolio or selling them in the secondary market. The MPF® Program allocates the risks associated with home mortgage lending between the Bank and its members in a

manner that uses the cooperative structure and capital market access of the Federal Home Loan Banks to maximize the comparative advantages of the financial institution member and the Bank.

Under the MPF® Program, Bank members market, service and credit enhance home mortgage loans, the funding for which comes from the Bank. Rather than paying a guarantee fee to a secondary market securitizer, members receive a fee for their credit expertise, well documented by their credit performance over long time periods. The Bank manages the liquidity, interest rate and options risk of the loan. In this way, the component risks involved in home mortgage lending are optimally allocated.

The MPF® Program is designed to help depository institutions more successfully compete against the capital and other advantages of Fannie Mae and Freddie Mac and expand their mortgage lending business in their communities.

2. Benefits

Homebuyers benefit from increased competition, efficiency and flexibility in the home mortgage loan market, which will lower costs to consumers. Participating members are able to provide home mortgage loans to more customers on more flexible terms, while realizing fees for mortgage origination, credit enhancement and servicing.

The Program uses the unique cooperative characteristics of the Federal Home Loan Bank System to offer a third alternative in housing finance that maximizes the strengths of each participant at the local level, where access to credit can be delivered more flexibly. Member institutions, particularly smaller thrifts and community banks, benefit from the program which makes them more competitive in the marketplace, while carrying out the housing finance mission of the Federal Home Loan Bank System.

B. Effect of the Proposal

The Proposal would not change the current risk-based capital treatment for member institutions participating in the Mortgage Partnership Finance® Program.

C. Recommended Revisions to the Proposal

In the Proposal, recourse transactions are eligible for "face-value treatment" if they have "traded" positions and are "externally rated." We believe that the recourse products in the MPF Program would meet the "traded" definition as the positions are traded among the Federal Home Loan Banks. We would urge the Agencies to revise the "externally rated" definition to allow "qualifying rating software," which uses the same analytics as in a formal external rating, to satisfy the externally-rated requirement. The result would be that the same methodology used in a formal rating would apply to these recourse transactions and thus, the policy goals of the Agencies would be met. Under this approach, in the sales of closed mortgage loans, a financial institution's limited credit enhancement would receive face-value treatment utilizing the same gradations of risk-based capital required for "qualifying rating software - direct credit substitutes" in the Proposal.

Secondly, although not expressly discussed in the Proposal, the current risk-based capital regulations of the Agencies require the holding of risk-based capital by a financial institution against a recourse credit risk position even if a third party has acquired a participation or provided indemnification for that risk position. Under the current regulations, if the financial institution retains any residual liability in the position, risk-based capital must be held as if the entire position had not been transferred or indemnified against.

Where a risk position is indemnified by a third party, the financial institution which is originally obligated on that position should hold risk-based capital that relates to the creditworthiness of the third party obligor, since the exposure to the third party is its actual risk. For example, if a recourse position is indemnified by an AA rated party then that position should receive AA "face-value" treatment [20% risk weight] in accordance with the chart in the Proposal. As the actual risk to the financial institution in such a transaction is the failure of the obligor, the credit rating of the party holding that obligation for the financial institution should trigger the relevant rating level and the relevant degree of risk-based capital.

V. CONCLUSION

Our views may be summarized by three key principles:

(1) Create the same risk-based capital for transactions with the same risks;

(2) Create a level competitive field for depository institutions vs. Fannie Mae and Freddie Mac; and

(3) Capital should reflect rigorous analysis of risk and historical experience.

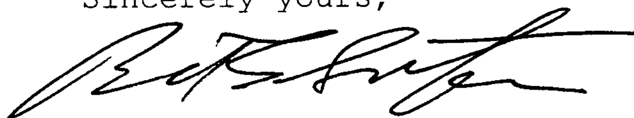
We have two specific recommendations for inclusion in the Proposal:

(1) Recourse positions which meet the "traded" definition should be allowed to utilize "qualifying rating software" to meet the "externally rated" requirement for face-value treatment.

(2) Recourse positions, where a portion of the credit risk has been participated to or indemnified by a third party, should receive a reduction in capital commensurate with the counterparty rating of that third party.

Thank you for the opportunity to comment on the Proposal. Should your staffs have any questions regarding this comment, please contact the undersigned at (312) 565-5805.

Sincerely yours,



Peter E. Gutzmer
Senior Vice President,
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