Mortgage Insurance Companies of America

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Executive Vice President

July 26, 2006

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

Re: RIN 2550-AA35

Dear Mr. Pollard:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on OFHEO's proposed technical amendments to the Risk Based Capital (RBC) regulation covering Fannie Mae and Freddie Mac as set forth in the Federal Register, vol. 71, no. 122, pp. 36231-36252 on June 26, 2006.

MICA applauds OFHEO's attempt with these amendments to address ongoing changes in the mortgage industry. As we have commented in the past, we have concerns about several limitations and structural problems of the RBC rule. We believe that a clear indication of the potential inadequacy of the model can be found in OFHEO's capital classifications. In three of the fifteen quarters in which the RBC model has been applied, the RBC calculation resulted in zero risk-based capital for Fannie Mae. While this is not an impossible result, it is highly unlikely that an adequate stress test would result in a zero capital requirement.

In light of these perceived deficiencies, MICA supports the modifications which recognize the additional risk presented by interest-only loans for single-family residences. OFHEO is correct to recognize the growing use of these loans, and the proposed treatment is consistent with other products and structural features of the RBC model. It is also consistent with our experience that products which feature delayed

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or negative amortization demonstrate increased frequency and severity of loss.

While we support this proposed modification, however, we must reiterate our previous comments regarding a more significant shortcoming of the RBC model. Most recently, MICA's comment letter of November 7, 2005[1] to OFHEO noted that the GSEs have not considered the combined LTV of piggyback mortgages when purchasing first or second liens or mortgage backed securities issued by others that include high-LTV mortgages. Just as the delayed amortization of interest-only loans causes higher losses through OFHEO's probability of negative equity (PNEQ) variable, so too should the addition of a second lien. In fact, piggyback loans represent a far bigger problem in the current RBC rule for three reasons. First, the use of piggyback loans is far greater than the use of interest-only loans.[2] Second, the impact of piggyback loans on loss frequency is considerably larger than that of interest-only loans. And finally, the RBC rule not only fails to capture the increased risk caused by piggybacks, it actually decreases the required capital because of the increased guarantee fees collected by the GSEs on piggybacks.

Loans structured into first and second liens for sale of one or both components to GSEs are structures expressly designed to evade both the credit-enhancement and loan limit requirements. Simply put, a second lien is not one of the forms of credit enhancement expressly mandated in both of the GSE charters. The banking agencies require a combined LTV

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[1] Letter to David A. Felt, Acting General Counsel from Suzanne Hutchinson, Executive Vice President, MICA, dated November 7, 2005 commenting on OFHEO request for comments for areas to be addressed in a new round of rulemaking.

[2] A *Wall Street Journal* story of April 19, 2006 , "New Fixed-Rate, Interest-Only Mortgage Surges in Popularity", by Ruth Simon references a statement by UBS AG that these fixed-rate I/O loans now account for roughly 8 percent of all new mortgages taken out. By contrast, SMR Research Corporation reported that "[f]or single family home sales in the fourth quarter of 2005, 42.9% of all homes sold with financing were piggyback deals in all counties with available data. The combined amounts of the piggyback loans were 52.3% of all dollars borrowed."

approach in setting safety and soundness standards. Standard & Poors recently revised their mortgage risk model to penalize pools with excessive exposure to loans with second liens.[3] OFHEO can and should do the same, as well as enforce appropriate rules to ensure full and transparent charter compliance. The RBC regulation should reflect the added risk associated with piggyback mortgages when either component loan is held by a GSE. The current RBC rule fails to do so and should be amended. The RBC rule should reflect the combined LTV of both the first lien and second simultaneous lien when either loan is held by a GSE. As we noted in our November, 2005 comments:

> A loan with a CLTV over 80% performs both in terms of frequency of default and severity of default like a single lien with an initial LTV over 80%. Thus, a piggyback 80/20 loan performs akin to a single lien with 100% initial LTV. The fact that a GSE is holding only the first lien with a putative 80% LTV does not change the fact that the borrower's initial equity in the loan was only equivalent to that of, in this example, a 100% initial LTV single lien. The same holds true for 80/10 and 80/15 piggyback liens. The risk to the GSE of these piggyback loans is the same risk as associated with uninsured single liens of 90%, 95% or 100% initial LTVs.[4]

In the Federal Register Notice of April 19, 2006, OFHEO responded to our concern about piggyback loans to the effect that "the Enterprises are already limited to the purchase of mortgages and mortgage-backed securities that are similar in risk to those with an 80% LTV."[5] However, this is clearly not the case for

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[3] See "S&P's Rating of Mortgage Pools Is Revised Amid Exotic Lending," by Allison Bisbey Colter, *Wall Street Journal*, June 15, 2006 p. D3..
[4] MICA letter to David Felt, op.cit.., p.6..
[5] Federal Register, Vol. 71, No. 75, Wednesday, April 19, 2006 p. 19986.

first liens that are part of piggyback mortgages. The borrower's equity in a true 80% initial LTV loan is 20% and the risk to a GSE associated with that loan is far different from one where the borrower's initial equity in the loan is 10%, 5% or zero. The RBC regulation should levy a risk-weight on mortgage loans held by GSEs that reflect the initial combined LTV of the loans at origination. The necessary data is known to the GSEs at the time of purchase and the RBC regulation should reflect the true risk of these loans.

Finally, as also urged in MICA's comment letter of November 7, 2005, OFHEO should institute a formal process to consider safety-and soundness implications of GSE programs, products and activities. As we have previously noted, OFHEO should by rule expand upon the current prior notice for new activities required by the Department of Housing and Urban Development to analyze all such ventures from a complete safety-and-soundness perspective, including a review of appropriate regulatory capital. If current GSE minimum capital ratios are not sufficient, then the GSEs' risk-based capital ratios should be adjusted to reflect not only the appropriate risk-based capital requirement, but also the appropriate amount of minimum capital. To ensure a full understanding of all prudential risks related to a new venture, OFHEO should ensure it receives timely public comment on each proposed activity.

Sincerely,

Suzanne C. Hutchinson