

January 17, 2002

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

Re: OFHEO's Proposal to Amend its Risk-Based Capital Regulation

Dear Mr. Pollard:

PMI Mortgage Insurance Co. is pleased to submit to you our comments on the proposed amendments to Appendix A Subpart B of 12 CFR 1750 Risk-Based Capital announced on December 11, 2001 ("Regulation").

We were encouraged to see that OFHEO is proposing to reduce the haircut differential between AA and AAA-rated mortgage insurance from ten percentage points to 5.25 percentage points, to lengthen the phase-in period for the haircut from five to ten years and to utilize recovery rates in calculating the final capital haircut. We fully support the lengthening of the phase-in period, and believe that the reduction in the AA/AAA differential and utilization of recovery rates in calculating the final haircuts are steps in the right direction. However we continue to believe that any differential in the haircut for AA and AAA-rated mortgage insurance is not supported by the pertinent data and contradicts the conclusion drawn by every other financial regulator, both domestic and international, that has considered this issue. Further, we believe that OFHEO's stress test model and not bond default studies is the appropriate proxy to be used to judge the risk of default of mortgage insurers. Nevertheless, the data in the bond default studies supports a lower assumed default rate for AA-rated counterparties and higher recovery rates, particularly for mortgage insurers. The data and logic for these conclusions is more fully described in Appendix A. In addition Appendix A contains information on why the proposed 10-year phase-in period should be maintained.

PMI recommends the following change:

Eliminate the differential in the haircut between AA and AAA-rated mortgage insurance for purposes of the risk-based capital regulations. This change will avoid the unintended consequences of reduced availability of mortgage insurance, a reduction in affordable housing programs, rising costs for homebuyers and

increased exposure of the U.S. taxpayers by a change in the business practices of the GSEs and their partners if the Regulation is not changed.

In addition, the industry trade association, Mortgage Insurance Companies of America (MICA), has submitted a comment letter on the proposed amendments. MICA's letter, in addition to commenting on the capital haircuts for AA and AAA-rated counterparties, also commented on four other issues:

1. Haircuts for unrated seller/services;
2. Credit derivatives;
3. Spread accounts,
4. Structured loans; and
5. Transparency of OFHEO's model.

PMI agrees with, and endorses, MICA's comments on each of the above listed issues.

Background

PMI Mortgage Insurance Co. is one of the largest mortgage insurance providers in the United States, Australia, New Zealand, Hong Kong and the European Community with nearly \$137 billion of mortgage insurance and over 1.5 million policies in force that have enabled families to achieve the dream of homeownership. Approximately 70 percent of the \$108 billion in mortgages that PMI insures in the U.S. are held by either Fannie Mae or Freddie Mac (collectively "the Enterprises"). Thus OFHEO's risk-based capital regulations, specifying capital haircuts for mortgage insurance on loans owned or securitized by the GSEs, have a significant and direct impact upon PMI's business, the families who are able to achieve homeownership with the assistance of PMI's insurance, and the approximately 1,800 lenders whose needs we serve.

For over forty years, the mortgage insurance industry has been a reliable, stable, and predictable risk share partner to the mortgage finance industry, paying in full more than 99.7% of all claims. We effectively settled billions of dollars of insurance claims through the most severe real estate downturns since the Depression of the 1930's. For example, the mortgage insurance industry paid more than \$6 billion in claims to its policyholders in the 1980's alone. Without our industry, the Oil Patch, New England, and Southern California real estate depressions could have threatened the viability of the Enterprises and the modern mortgage finance system. Importantly, our industry followed through on its commitment with no risk to taxpayers or support from the United States government.

The mortgage insurance industry has also been at the forefront in promoting affordable housing opportunities. PMI has a long history of providing specially developed affordable housing programs, and in total has insured over \$116 billion in low- and moderate-income loans. We exist to expand homeownership opportunities for first-time homebuyers and families of modest

economic circumstances. A more detailed discussion of PMI's affordable housing activity is contained in Appendix B to this letter.

Numerous housing/mortgage market experts including the Joint Center for Housing Studies of Harvard University have forecast that upwards of one-third of all first-time homebuyers in this decade will be minorities and immigrants, as these families avail themselves of greater financing opportunities and strive to achieve homeownership rates that will approach the levels enjoyed by the U.S. population at large. These families will have demonstrated the ability to manage their finances, and will have the income to meet their mortgage and other financial obligations. Most will have savings sufficient to make at most a downpayment of 3 – 10%, and thus will require mortgage insurance to obtain a loan. Hence the cost and availability of private mortgage insurance is a very real issue for low and moderate-income families.

It is within the context of this background that we offer these comments on OFHEO's proposed amendments to the Risk-Based Capital Regulation.

Comments

We believe that OFHEO should make no distinction in the haircut differential between AAA and AA-rated mortgage insurance.

This is supported by the approach of the U.S. banking regulators, the draft Basel Accords, the rating agencies, the rating of the Enterprises, claim paying experience on mortgage loan defaults since the Depression and bond default studies in general.

- i. *The default rates assumed by OFHEO in the regulation rely heavily on data from the Depression era. The available data on corporate bond default experience is less reliable for the Depression period than for more recent years, which include periods of substantial stress. It cannot be disputed that there have been profound changes in the U.S. economy generally, and the financial markets in particular, since the Depression, so that data from that period is inherently unlikely to be "consistent with the stress period," which is actually based on the economic stress experienced in several southwestern states in the early 1980s.*

Use of Depression data is not consistent with, and also contradicts, the requirements of OFHEO's enabling legislation. See 12U.S.C.4611(a) and 12U.S.C.4611(b). Considering the clear statutory requirement that the Regulation should be formulated in the light of various factors "consistent with the stress period," OFHEO's heavy reliance on Depression-era data to assign dramatically different haircuts to AAA- and AA-rated private mortgage insurers is inappropriate. If bond

default data is to be used, more recent data, including data from the early 1980s should be used and it shows little or no difference in the default rates of mortgage insurers in the top two rating categories.

- ii. *OFHEO chose 1983 and 1984 as the relevant historical period for the credit risk portion of the stress test. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, provides the basis for OFHEO's stress test and requires that characteristics of the stress period not specified explicitly in the law be consistent with the characteristics of the stress period chosen as the relevant historical period. The Senate Report on the 1992 law comments on this issue directly: "The legislation deals most carefully with the projection of losses associated with mortgage defaults and interest rate changes, but other factors may have a significant effect on GSE survivability. The Director will need to explicitly consider such other factors as mortgage prepayment rates, non-interest expenses, dividend policies, fee and investment income, taxes and financing strategies. In making assumptions about these variables, the Director should endeavor to make them as consistent as possible with the interest rate and default characteristics of the stress test." Senate Report 102-282, Federal Housing Enterprises Regulatory Reform Act of 1992 (May 15, 1992), page 23. Reliance on Depression era data is not consistent with the stress test. Further, bond default studies are not an appropriate measure of the risk of default of mortgage insurers.*

In examining the Moody's data from the stress period, it shows that for the cohorts formed in 1983 and 1984, the ten-year cumulative default rates for AA cohorts were 2.0 percent and 1.8 percent, respectively. This is substantially less than OFHEO's proposed calibration of AA nonderivative counterparty haircuts to a default rate of 8.75 percent. Also, this 1983-84 stress period experience shows that parity of AAA and AA default rates is the most reasonable calibration of the OFHEO counterparty haircuts. For the 1983 and 1984 cohorts, the cumulative ten-year default rates for AAA cohorts actually were slightly higher than the AA experience (2.7 percent and 2.1 percent, respectively). (Source: Moody's Jan. 1997 publication, "Historical Default Rates of Corporate Bond Issuers, 1920-1996").

The Depression era bond default data pertains to a period with a significantly different industry mix of bond issuers than the present. Actual default rates from the Depression period were dominated by issuers from the transportation sector, whereas the current economy—and the GSE's counterparty risk profile—is much more oriented toward financial firms and financial instruments.

Even with the proposed amendments, the Regulation, as published, could lead to capital differentials that will effectively distort competitive market forces that have spread business risk among 8 companies and thus provide a potentially significant and unjustified advantage for AAA-rated mortgage insurers over AA-rated mortgage insurers. Further, the government's unprecedented intervention will create unfair financial advantages that will enable AAA companies to leverage the government-mandated incentives to capture a greater and disproportionate share of the MI business. This advantage would lead to a concentration of counterparty risk for the Enterprises, thereby endangering the safety and soundness of the Enterprises. Congress recognized the inherent danger of lack of risk diversification for the Enterprises in OFHEO's enabling legislation. The purposes of the enabling legislation is to ensure that the Enterprises will have capital sufficient to withstand severe financial stress for a prolonged period of time. Concentrating the Enterprises risk in their low downpayment mortgage portfolio with two mortgage insurance providers, rather than spreading that risk among 8 well capitalized mortgage insurers weakens, rather than strengthens, the Enterprises' ability to withstand severe financial stress, potentially increasing the exposure of the U.S. taxpayers.

Equally important are the consequences to homebuyers. Concentration of pricing power into AAA-rated insurers will increase the cost of homeownership because rather than having 8 well capitalized providers to choose from, consumers will be largely confined to dealing with 2 AAA-rated companies. Additionally, the Regulation will stifle product innovation for high LTV, low- and moderate-income borrowers. The mortgage insurance industry has been a creative and willing partner of the Enterprises in developing products that enable the Enterprises to meet the ambitious affordable housing goals established by HUD. Serious contraction within the mortgage insurance industry, created by the consequences of the Regulation, will leave a vacuum that is unlikely to be filled by competing credit enhancements. Homeownership levels for the most vulnerable segments of our society will suffer.

In addition, mortgage insurance companies, if they are able to upgrade their ratings, may very well be forced to reduce the size and scope of their business and may have to cut back their presence in smaller states and smaller markets that they now serve. These cutbacks would result from the higher capital requirements dictated by the AAA/AA differential in the regulation.

Furthermore none of the federal banking regulators, nor international banking regulators, draw a distinction between AA and AAA-rated counterparties as OFHEO has done. This equivalent treatment of AA and AAA-rated counterparties was seen most recently in the FDIC risk-based capital regulations that were issued late last year.

Conclusion

To summarize PMI's position:

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Eliminate the differential in the haircut between AA and AAA-rated mortgage insurance for purposes of the risk-based capital regulations. This change will avoid the unintended consequences of reduced availability of mortgage insurance, a reduction in affordable housing programs, rising costs for homebuyers and increased exposure of the U.S. taxpayers by a change in the business practices of the GSEs and their partners if the Regulation is not changed.

Best regards,

W. ROGER HAUGHTON