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January 10, 2002

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

Re: Comments on OFHEO's proposal to amend its Risk-Based Capital Regulation

Dear Mr. Pollard:

At the request of PMI Mortgage Insurance Co., I have thoroughly reviewed the proposed amendments to Appendix A, Subpart B of 12 CFR 1750 (Risk-Based Capital), announced on December 11, 2001 (the "December Proposal") and offer the following comments.

This letter focuses in particular on the proposal to continue applying different capital "haircuts" to AAA-rated and AA-rated mortgage insurance companies, albeit with a somewhat smaller difference than that reflected in the risk-based capital regulation issued by OFHEO in September 2001 (the "September Regulation"). This letter also reiterates the conclusions expressed in my previous letter to Mr. Armando Falcon, Director of OFHEO, dated October 12, 2001, to the effect that the disparate capital treatment OFHEO has adopted for AAA-and AA-rated mortgage insurers is not justified. A copy of that letter is attached for your convenience.

I believe that the comments offered below should lead OFHEO to conclude that any distinction between mortgage insurance companies in the two top investments grades in arriving at minimum capital standards for Fannie Mae and Freddie Mac is artificial and unwarranted. As you know, the September Regulation currently specifies haircuts of five percent for AAA-rated mortgage insurance companies and 15 percent for AA-rated insurers. The December Proposal would lower these haircuts to 3.5 and 8.75 percent respectively. In addition, it would extend the phase-in period from five to 10 years, a change that I believe is appropriate.

I. Background and Experience

Before explaining the basis for my conclusions regarding the December Proposal, I should summarize my relevant background and experience. In 1997 I retired as an officer of the Board of Governors of the Federal Reserve System having spent more than 30 years in banking supervision and regulation. From 1964 until 1982 I was employed by the Comptroller of the Currency, first as a National Bank Examiner and later as a Division Director. For two years beginning in 1982 I served as Deputy Executive Secretary and Coordinator of State Liaison Committee Activities at the Federal Financial Institutions Examinations Council and in 1984 joined the Federal Reserve. As Assistant Director, Division of Banking Supervision and Regulation at the Federal Reserve, I was involved in the full range of supervisory and regulatory policy matters pertaining to the safety and soundness of State member banks and bank holding companies.

Particularly relevant to the issues under discussion, I was a voting member of the capital liaison committee that meets under the auspices of the Bank for International Settlements in Basel, Switzerland and was directly involved in the development, implementation and subsequent enforcement of the 1988 Basel Accord. As you know, the Accord established the first internationally recognized risk-based capital standards for the banking industry. In conjunction with the other United States bank supervisory agencies I helped developed and implement the regulations and guidelines that applied the Basel standards to U. S. financial institutions and I was also responsible for the interpretation and enforcement of the risk-based capital guidelines for State member banks and bank holding companies. My other policy development work at the Federal Reserve covered such areas as asset securitization, lending limits, regulatory reporting and accounting as well as the development of the financial regulatory agencies' uniform real estate lending standards. I also represented the Federal Reserve as a voting member of the Appraisal Subcommittee of the Federal Financial Institutions Examination Council, which was charged with implementation of the real estate appraisal reforms mandated by Title XI of FIRREA.

In preparation for making these comments I have studied OFHEO's December Proposal in detail and have thoughtfully considered the data and reasoning set forth as its justification. I have reviewed the risk-based capital guidelines of the Federal Reserve System for banks and bank holding companies as well as the capital standards of the other financial institution supervisory agencies and the uniform standards of real estate lending adopted by the agencies in 1992. I have also reviewed the 1988 Basel Accord and the 2001 proposals for updating the Accord, as well as the rule on the capital treatment of recourse arrangements and other credit substitutes recently issued jointly by the federal banking agencies.

II. Summary of Points in My First Letter

At the outset I would like to summarize the points I made in my earlier letter to OFHEO. The financial institution supervisors in the United States do not--and have never--differentiated between AAA-and AA-rated insurance companies. Regardless of the credit rating of the mortgage insurer, high loan-to-value mortgages for which private mortgage insurance is necessary are accorded the same capital risk-weight as mortgages for which such insurance is not necessary. In developing their capital and real estate lending guidelines, the agencies certainly had an opportunity to differentiate between AAA-and AA-rated mortgage insurance companies had they viewed it to be in the public interest. They chose not to do so. To the contrary, U. S.

financial institution supervisors determined that is was unnecessary to prescribe minimum credit ratings for private mortgage insurers and concluded that any difference between the likely ability of AAA-and AA-rated companies to honor claims is not significant enough to justify disparate capital treatment.

Thus, a strong case can be made for OFHEO to abandon the current as well as the proposed distinction between AAA-and AA-rated mortgage insurance companies. Moreover, this case is strengthened when the Basel Accord and the current proposal to update it are taken into consideration.

Throughout the discussions, which began in the early 1980's and eventually led to the Basel Accord, the United States considered the treatment of real estate loans for capital adequacy purposes, particularly loans secured by single family residences, as vitally important to our national interest. The United States as you know, unlike most other countries, has a very high percentage of owner-occupied dwellings. This favorable circumstance is due in large measure to our highly efficient and very successful secondary market for mortgage-backed securities. United States representatives in Basel fought long and hard to protect our real estate financing market from unrealistic and arbitrary capital limitations sought by several countries with significantly different domestic housing patterns, far less sophisticated real estate lenders and little or no secondary marketing arrangements. In this connection, loan-to-value ratios and the secondary market for real estate mortgages in the U.S.--in which mortgage insurance plays such a key role--were the subject of considerable scrutiny on the broadest of safety and soundness grounds. In the end these exhaustive deliberations led U. S. and foreign supervisors to conclude that there was no safety and soundness reason to distinguish among high loan-to-value mortgages backed by private mortgage insurance on the basis of the credit standing of the insurer.

The 2001 proposal to amend the Basel Accord provides for different approaches for calculating minimum capital requirements: the standardized approach and the foundation and advanced methods of the internal ratings-based approach. None of the proposed approaches bases capital treatment of counterparties on a distinction between AAA- and AA-rated entities. Under both versions of the internal ratings-based approach, financial institutions must make their own internal estimate of each counterparties' creditworthiness. Ratings provided by external credit assessment institutions, such as Moody's and Standard and Poors, are not utilized.

The two internal ratings-based methods are by their nature only suitable for the most sophisticated institutions. Fannie Mae is one of the largest corporations in the United States and ranks among the largest financial service companies in the world. It utilizes complex and exacting interest rate risk-mitigation strategies, and manages the credit risk associated with the billions of dollars of mortgage instruments that it owns or guarantees by careful underwriting standards, nationwide geographical diversity, and substantial borrower equity--averaging 40 percent. Freddie Mac is also a very large, conservatively operated and highly successful corporation employing similar safeguards. Consequently, if Fannie Mae and Freddie Mac were subject to the proposed Basel standards they would certainly rank as sophisticated instituions and could qualify to use their own internal estimations of counterparty creditworthiness to access their risk exposure and minimum capital requirements.

In this connection, it must be noted that, as world leaders in the securitization of mortgages and the marketing of secondary mortgage instruments, neither Fannie Mae nor Freddie

Mac has found it appropriate to differentiate between AAA-and AA-rated mortgage insurers.[1] And, even more significant, investors in Fannie Mae and Freddie Mac securities make no such distinction.

The standardized approach for calculating minimum capital levels in the Basel proposal is suitable for less sophisticated financial organizations. While it does rely heavily on credit ratings provided by external credit assessment institutions, it makes no distinction between AAA- and AA-rated obligors or claimants. Across the whole spectrum of bank assets and transactions, sovereign, central bank, commercial bank, securities and corporate counterparties rated AAA and AA are treated identically. Claims fully secured by mortgages or residential property, whether owner occupied or rented are assigned the same risk weight and mortgage insurance used to mitigate the higher risk associated with high loan-to-value ratios is accepted without regard to the credit rating of the company providing the mortgage insurance coverage.

III. The New OFHEO Proposal

Even though the December Proposal reduces the differential between the haircuts for AAA- and AA-rated mortgage insurance companies, analysis of the relevant data demonstrates that the differential now proposed is not justified. The 8.75 percent haircut OFHEO is proposing for AA-rated non-derivative contract counterparties – fully 2.5 times the haircut proposed for AAA-rated counterparties -- is the product of multiplying a default rate of 12.5 percent by a loss severity estimate of 70 percent. For the reasons set forth below, I believe that both of these multiplicands are too high. The data presented in OFHEO's proposal are skewed by over-reliance on Depression-era default rates, and do not support a haircut for AA-rated mortgage insurers that is 2.5 times higher than that for AAA-rated mortgage insurance companies.

The following discussion explains why data on more recent stress periods are more relevant for predicting the likely future performance of AAA-and AA-rated securities than the data encompassing the 1920's and '30's used in OFHEO's analysis. First, with respect to the default rate, using the data cited in OFHEO's proposal, the worst average 10-year default rate for AA-rated investment grade obligors since 1920, according to the findings of Moody's Investors Services, was for the cohorts formed in the years 1929 to 1931, and amounted to 12.25 percent. According to the analysis of W. Braddock Hickman, the 12-year default rate for a cohort of AA-rated issuers formed in 1928 was 12.3 percent. Both these default rates, based on data from the Depression, are less than the 12.5 percent default rate proposed by OFHEO.

Moreover, these studies began in the late 1920's and are necessarily distorted by the events of the Great Depression, which took place before the U. S. made several fundamental changes in the way the economy is managed. These changes and their positive effect on the U.S. financial marketplace need to be taken into account in any important analysis. This strongly suggests that the cited data overstate, rather than reasonably reflect, today's likely default rates even in a period of extraordinary economic stress.

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[1] Fannie Mae and Freddie Mac in their comments before the September Regulation was adopted criticized OFHEO's proposal to specify haircuts of ten percent for AAA-rated mortgage insurance companies and 20 percent for AA-rated mortgage insurers. Fannie Mae proposed credit default haircuts, adjusted to reflect a 50 percent recovery rate, of 1.5 percent for AAA-rated insurers and 2.0 percent for AA-rated insurers. Freddie Mac also commented that a 50 percent rate recovery was appropriate and proposed haircuts of 1.2 percent for AAA- rated insurers and 1.5 percent for AA-rated insurers. Not only are these haircuts drastically smaller than those proposed by OFHEO but the difference between the treatment of AAA- and AA-rated mortgage insurance companies is also very much smaller than what OFHEO is still proposing.

To put it another way, OFHEO is proposing to use a default rate slightly higher than the acknowledged average worst 10-and 12-year default rates cited in its own proposal, which applied to bond issues in the Depression era. By proposing to use such a high default rate, OFHEO seems to be discounting all of the policy, legislative, regulatory and supervisory safeguards instituted since the late 1930's to manage the U. S. economy and protect financial institutions.

Looking at monetary policy alone, right up until the late 1930's the Federal Reserve consistently failed to follow a course that could have stimulated the economy. And, in fact, even after the Treasury began its first meager steps at fiscal expansion, the Federal Reserve pursued a contradictory monetary course until 1938. There is no serious dispute that these failures of monetary and fiscal policy greatly exacerbated the credit problems of the Depression. Nowadays, such uncoordinated and even contradictory actions by the Treasury and the Federal Reserve in a period of serious economic stress would be extremely unlikely.

Moreover, the economic landscape has been profoundly transformed in other ways. The Securities and Exchange Commission and the federal deposit insurance system were established to protect investments and savings. And, Social Security and the wide availability of unemployment benefits were created to provide an economic safety net for working Americans. These and many other institutions and government programs established since the Depression serve to mitigate the severity of economic downturns.

Given all of the economic safeguards that are now in place, any concern OFHEO may have that the misdirected and uncoordinated fiscal and monetary policies and other economic characteristics of the 1930's would be reproduced in this day and age is simply not justified. There is no basis for OFHEO rely on Depression-era bond default data to adopt a higher default ratio for AA-rated mortgage insurance companies than for AAA-rated companies.

Furthermore, there is reason to question the usefulness of the Hickman and Moody's data even with respect to the Depression years. For example, while Hickman's analysis of default rates is essentially consistent with Moody's findings for AA-rated obligors, he reports a default rate of 8.1 percent with respect to AAA-rated obligators (in other words, the AA default rate of 12.3 percent is 1.5 times the AAA default rate). On the other hand, Moody's estimates the default rate for AA-rated issuers at 12.25 percent, or 2.6 times the rate it found for AAA-rated issues (4.75 percent). Such a significant disparity between the findings of acknowledged experts suggests that the underlying data are not sufficiently precise to be used as a basis for a regulatory capital standard that significantly discriminates between the two highest investment grades. Yet, OFHEO is proposing a very significant difference between the haircuts it would apply to mortgages backed by AAA-rated mortgage insurance companies and those backed by AA-rated insurers.

In January of last year Moody's Investors Services issued a special comment entitled "Historical Default Rates of Corporate Bond Issuers 1920-1999". Among other data, this study presents the average cumulative default rates broken down by the credit rating of the issuer for cohorts of securities established in consecutive years. It shows an average 20-year default rate for AAA- and AA-rated issues for cohorts established in the years 1970 through 1980. For these 11 cohorts the average 20-year cumulative default rate for AAA-rated issues was actually five basis points higher, at 2.38 percent, than the average 20-year cumulative default rate for AA-rated issues, which was only 2.33 percent. Moreover, in six out of these 11 years the cumulative 20-year default rate for AAA-rated issuers was actually higher than the rate for AA-rated issuers. This is not to suggest that in the main AA-rated securities are less likely to default than AAA-

rated securities, but again simply points out the vagaries of the underlying data and the overall similarity between the default rates for AAA- and AA-rated issuers in non-Depression skewed periods.

Looking at shorter average cumulative default rates for AAA-and AA-rated securities also confirms that there is really no valid statistical basis for OFHEO to differentiate between AAA-and AA-rated mortgage insurance companies in its risk-based capital regulation. Cohorts formed in the years 1981 through 1990 show an average 10-year default rate for AAA-rated securities of 1.18 percent compared to 1.47 percent for AA-rated securities (a difference of 29 basis points or 8 percent). Again using OFHEO's style of comparison, the 10-year default rate for AA-rated issuers was only 1.24 times that of AAA-rated issuers. And, in four of these years the cumulative 10-year default rate for AAA-rated issuers was actually higher than the rate for AA-rated issuers.

Moreover, it must also be noted that the data utilized in all of the analyses discussed above cover investment grade obligors in general, and are not specific to the historical ability of individual insurance companies to honor their contracts.

When one steps back and looks at these data it becomes very clear that they are skewed by the Depression and moreover are neither sufficiently consistent nor precise enough to serve as a basis for making a significant regulatory distinction between the credit quality of AAA-and AA-rated insurers. This is particularly true when the sweeping probable economic impact of OFHEO's current rule, even if modified as proposed, is considered. All of this leads to a very important conclusion: OFHEO should treat AAA-and AA-rated mortgage insurance companies the same for assessing the risk-based capital of Fannie Mae and Freddie Mac.

This concern about OFHEO's proposed approach is heightened because differentiating between the top two rating levels of mortgage insurance companies will certainly result in a tiering in the market for such coverage and the mortgage assets they support. Such tiering would directly impact mortgage lenders and consumers by raising costs and lessening competition. At the same time a significant shift to AAA-rated insurers encouraged by an artificial cost differential created by regulatory requirements rather than market forces could lead to greater concentration of risk among fewer insurance companies, thus weakening rather than strengthening the industry.

Looking at the proposed loss severity rates raises the same concerns as those raised by the default rates. The data cited by OFHEO at page 6 of the copy of the December Proposal attached to the December 11th news release (at page 65148 in the Federal Register version) strongly support a recovery rate of 40 percent or more. Yet the loss severity multiplier of 70 percent proposed by OFHEO results from an assumed recovery rate of only 30 percent, which is at least 25 percent smaller than what may reasonably be expected.

OFHEO should make every effort to align its capital requirements with the internationally recognized standards adopted by the other U. S. financial institution supervisors, unless there is a clear and readily demonstrable safety and soundness reason to adopt a variant approach. In this instance, given the historic claims-paying performance of insurance companies in the two top ratings, there is no basis for concluding that the public interest in a safe and sound marketplace for mortgage backed securities is served by the treatment set forth in OFHEO's current rule nor in the proposed amendment. Conversely, as discussed above, many of the consequences of the rule may in fact undermine the stability of the market and increase rather

than reduce the normal business risks associated with the activities of Fannie Mae and Freddie Mac.

Consequently, the risk-based capital distinction between AAA-and AA-rated mortgage insurance companies in OFHEO's September Regulation should be eliminated and companies in these two top investment grades should be treated the same.

Very truly yours,

Rhoger H Pugh