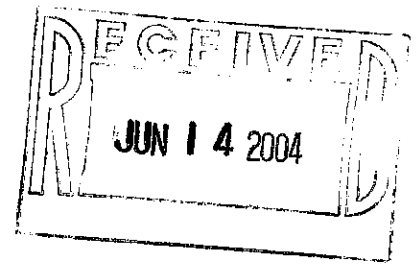




**Mortgage
Insurance
Companies
of America**

Suzanne C. Hutchinson
Executive Vice President

June 11, 2004



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

RE: Comments/RIN 2550-AA24

Dear Mr. Pollard:

The Mortgage Insurance Companies of America (MICA) is pleased to comment on OFHEO's proposed new corporate governance standards (69 *Federal Register* 24,115) for Fannie Mae and Freddie Mac (the Enterprises or GSEs). We strongly concur with the premise of the proposal: effective corporate governance is vital to safety and soundness. Indeed, it is even more important at Fannie Mae and Freddie Mac because, as Chairman Greenspan has made clear, the implicit guarantee behind them seriously dulls market discipline that would otherwise push boards of directors and senior management to take steps and control risks that now may go ignored.¹ The huge size of these Enterprises also raises the danger that corporate governance failures could trigger a loss of market confidence that would, in turn, lead to the systemic-risk scenarios outlined in the OFHEO systemic-risk report of February, 2003.² Bank regulators have rightly recognized that effective corporate governance is an essential part of

¹ Testimony of Federal Reserve Chairman Alan Greenspan before the Senate Committee on Banking, Housing and Urban Affairs. (February 24, 2004).

² *Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*, Office of Federal Housing Enterprise Oversight (February, 2003).

operational risk management, making it clear that OFHEO must intervene to ensure it at the GSEs.³

In the proposal, OFHEO notes, "Since their creation, the Enterprises have grown to become two of the largest financial companies, yet the Enterprises are highly leveraged." MICA strongly concurs, and we continue to believe that the risk-based capital (RBC) rules governing Fannie Mae and Freddie Mac do not fully capture all of the risks that pose such significant hazard not only to the GSEs, but also to housing and financial markets more generally.⁴ The RBC rules, for example, now permit the GSEs to offset credit risk with interest-rate risk mitigation and vice-versa - despite the fact that these two risks are strongly correlated in mortgage finance. Weak corporate governance allows the GSEs to exploit failures in the RBC standards by, for example, using credit risk transfer structures that capture the benefits in the RBC models even if risk is not in fact transferred to a reliable and independent third party. Effective corporate governance is especially vital at the GSEs to ensure that they do not structure transactions to "game" the RBC rules or other requirements. As discussed in more detail below, MICA recommends that the board responsibilities explicitly include monitoring and, if necessary, action related to complex transactions to prevent structures that do not reflect transactional economic realities.

General Corporate Governance Framework

In these comments, MICA focuses on safety- and-soundness issues related to GSE credit risk, as this is our specific expertise. We do not, therefore, address the broad corporate governance questions posed in this proposal. However, below we discuss specific amendments to these proposals that OFHEO should include in the final rule.

³ *Pillar 2 (Supervisory Review Process)*, Consultative Document, Basel Committee on Banking Supervision, Bank for International Settlements (January, 2001).

⁴ 12 C.F.R. Part 1750

Codes of Conduct

OFHEO is proposing to amend Section 1710.14 of its current rules by adding the requirement that the GSEs develop a specific code of conduct to supplement the general code of conduct already required by OFHEO. This requirement is similar to the specific code of conduct standards mandated for publicly-traded companies in Section 406 in the Sarbanes-Oxley Act (SOA) and by New York Stock Exchange standards. Consistent with SOA, the OFHEO rule would require the GSEs to have "reasonable" standards to, among other things, bar conflicts of interest and to ensure legal and regulatory compliance with existing laws. MICA suggests that OFHEO also require the following:

- *Activities* - OFHEO should ensure that the ~~specific codes of conduct mandate that the~~ GSEs comply with applicable rules and regulations including their charter acts, the Department of Housing and Urban Development's (HUD) new-program prior approval standards (24 C.F.R. § 81.51), and HUD's affordable-housing rules (65 *Federal Register* 65,044 and 69 *Federal Register* 24,228). MICA believes that this clarification will ensure that OFHEO has full authority, as it must, to implement safety-and-soundness enforcement actions should GSE practices result in non-compliance with rules that do not explicitly come under OFHEO. The agency has previously made clear that new programs can pose safety-and-soundness problems, but it may not learn of them until far too late because of an initial failure by an enterprise to obtain mandatory HUD prior approval.⁵
- *Economic Objectives* - OFHEO should direct that the GSEs engage in transactions structured solely to achieve their economic objectives, not to provide undue capital, tax or related gains that would not otherwise result from the most straightforward approach

⁵ OFHEO's FY 1998-2003 Strategic Plan, Office of Federal Housing Enterprise Oversight, pg.7. (February 10, 1998).

to the transaction. An example of a situation where a GSE engaged in a transaction where the true goal was other than what the GSE claimed it to be was Freddie Mac's MODERNS transaction. In its special examination, OFHEO rightly concluded in the MODERNS transaction, Freddie Mac actually retained risk that otherwise looked as if it was sent to third parties. The MODERNS transaction was an off-balance sheet structure that nominally transferred credit risk even though Freddie Mac in fact remained responsible for it. As the bank regulators have noted, structuring poses an array of risks - credit, legal, and reputational ones chief among them.⁶ The banking agencies and SEC are now in the process of formalizing this structuring guidance, and OFHEO should consider ~~comparable standards for Fannie Mae and Freddie Mac~~, as well as clarification of the corporate-governance rules to address this risk.

Finally, MICA supports OFHEO's proposal that the Enterprises review their codes of conduct at least every three years to ensure they are consistent with relevant best practices. However, we would recommend that OFHEO mandate that the codes be revised as required whenever a new market practice or a substantive change in law or rule defines new standards to which the GSEs must ensure compliance. As you well know, a range of major safety-and-soundness initiatives are underway within your agency and in Congress. If the GSEs do not update their codes quickly as new standards are mandated, they could be seriously out of date for a very critical period. Further, HUD is of course also revising its affordable-housing rules. A delay in coordinating code-of-conduct compliance standards with these enhanced requirements could similarly provide for a

⁶ The Federal Reserve Bank of New York and New York State Banking Department Enforcement Action against J.P. Morgan Chase; the Securities and Exchange Commission Complaint against J.P. Morgan Chase; the Federal Reserve Bank of New York and Securities and Exchange Commission Enforcement Actions against Citigroup; and the Office of the Comptroller of the Currency Enforcement Action against Citibank (July 28, 2003).

compliance loophole that would limit OFHEO's ability to implement needed enforcement actions.

Board Responsibilities

The OFHEO rule proposes to add a new Section 1710.15 That expands upon GSE board responsibilities. The rule would mandate that, among other things, directors remain apprised of "risk policy" and "programs for legal and regulatory compliance." The board annually would need to review with outside assistance the degree to which appropriate compliance had occurred. The proposal would also mandate board responsibility to ensure adequate corporate operational risk management. MICA supports these requirements, but again suggests that they be clarified to address specific concerns unique to Fannie Mae and Freddie Mac. The final rule should do the following:

- *Risk Policy* - The rule should specifically stipulate that "risk policy" means not only written policies and procedures, but also that the GSEs comply with them and an assurance that such risk policies are in conformity with applicable best practices. The rule also should have an affirmative duty to ensure that the risk policy is enforced.
- *Programs* - The rule should stipulate that board compliance obligations include responsibility to ensure charter compliance and adherence to the HUD new program prior-approval and affordable-housing rules cited above; and
- *Timing* - The rule should require that board "review" of legal and regulatory compliance occur quarterly, not annually. The rule should make clear that the board shall not only "review" legal and regulatory compliance, but also take steps to ensure compliance.

Consistent with numerous banking agency standards, we recommend that OFHEO both in the corporate-governance rule and in other safety-and-

soundness standards, stipulate that board responsibility is to set specific policies and procedures regarding corporate strategy, risk management and compliance (among other issues), instituting incentive structures and other major policies to ensure adherence to the stipulated policies and procedures. Senior management is then to implement the details of the policies and procedures, reporting to the board and being held accountable by it.⁷

Again, clarification here will ensure that OFHEO has established the necessary predicate to ensure boards comply with these essential safety- and-soundness issues, even though the actual regulations involved may not fall directly under OFHEO.

GSE Subsidiaries

In connection with the proposal to bar GSE insiders from receiving inappropriate extensions of credit, the OFHEO rule would govern any such extension from an Enterprise "subsidiary." MICA believes that this reference should be deleted to avoid any inference that OFHEO intends that the GSEs establish subsidiaries for any purpose, replacing the reference to subsidiaries with one that makes clear that the Enterprise may not arrange in any fashion for inappropriate extensions of credit. The degree to which an Enterprise may have subsidiaries, the manner in which its benefits support such subsidiaries, the degree to which the charters govern them and many other critical questions are yet to be addressed in GSE governing law and applicable regulation. Thus, we urge the agency to avoid any terminology that might lead the Enterprises at some point going forward to argue that OFHEO sanctions the establishment of subsidiaries. We would note that current law (12 U.S.C. § 1828(s)(1)) bars the Enterprises from affiliation with insured

⁷ See: 12 C.F.R. Part 30, Appendix A; Comptroller's Handbook – Internal and External Audits; OCC's Interest Rate Handbook; OCC Banking Circular 277 (October 27, 1993); OCC Advisory Letters 97-3 (March 11, 1997) and 95-1 (February 8, 1995); OCC Bulletin 2001-18 (April 9, 2001); and Federal Reserve Board Bank Holding Company Supervision Manual, Section 2126.0.3.1.

depositories, making it unlikely that extensions of credit could come from such subsidiaries.

Compliance and Risk Management

Proposed Section 1710.19 would require Fannie Mae and Freddie Mac to establish and maintain compliance programs headed by an officer reporting directly to the chief executive officer (CEO). The proposed section would also mandate establishment and maintenance by the Enterprises of a risk management function, with an individual designated to take on this responsibility who also would report to the CEO. Both the compliance and risk management officers would meet periodically with the board. MICA suggests several clarifications to the mandate for these essential functions in the corporate-governance standards. However, as discussed more below, we also urge OFHEO to expand quickly on these essential elements in separate safety-and-soundness regulations that will provide broader guidance for the Enterprises and additional examination and enforcement standards for OFHEO implementation.

Provided below are MICA's two recommendations on how OFHEO should clarify the corporate-governance rules. They are consistent with requirements mandated by the bank regulatory agencies.

- *Compliance Officer* - First, each business unit shall have a compliance officer who is to report to the lead compliance officer who in turn reports to the CEO. All such compliance officers are to be independent of their business units. Compensation for all compliance managers shall be set to ensure that incentives promote defined compliance objectives stipulated by the board of directors for which the CEO is held responsible.
- *Risk Management Officer* - Second, all divisions and departments shall have a designated risk management officer who shall report to the senior risk manager.

Compensation for all risk managers is to be set to ensure adherence to risk policies and procedures set by the board of directors for which senior management is held responsible. Compensation is to be independent of incentives that may distract from defined risk-management priorities.

MICA suggests that the corporate-governance rules further stipulate that the board audit and compensation committees review these corporate and compensation structures. A designated board committee should be established to ensure that compliance and risk-management standards conform to best practice in designated areas, with particular attention to legal and reputational risk.

Additional Compliance and Risk-Management Issues

As noted in the beginning of this letter, MICA believes OFHEO should, with various clarifications and expansions, finalize the proposed corporate-governance rules. However, we do not believe that the simple requirement in the proposed rule that compliance and risk-management functions be established deals adequately with the many potential problems at these huge Enterprises. We also believe that examinations alone are not sufficient to ensure best practices if OFHEO has not detailed what these practices are and ensures through its enforcement actions that compliance and risk management are indeed up to the world-class standards essential at firms that pose such grave systemic risk. We would note that bank regulators do not rely solely on examination, detailing in a wide range of rules, orders and guidances - as well as in-depth examination handbooks - just how their regulated entities are to ensure best-practice compliance and risk management.

MICA thus urges OFHEO quickly to act on various other initiatives identified in the regulatory infrastructure project in addition to these corporate governance requirements. Key new standards should include the following:

- *Operational Risk Management* - This should address not only system integrity, but also legal risk as proposed by the U.S. regulators in implementing the revisions to the Basel Accord.⁸ MICA is particularly concerned that operation risk standards protect the GSEs from undue reliance on untested counterparties unable to meet their obligations under stress;
- *Credit Risk Transfer Guidance* - Bank regulators are now in the process also of finalizing guidance here. This will ensure that banks rely only on tested credit risk transfer structures without undue legal risk, and the Enterprises should be bound now to comparable standards.
- *New Programs Related Risk* - The Office of the Comptroller of the Currency has recently provided guidance for national banks regarding board and management responsibility for the additional risk associated with any new venture. Of particular concern is the press for profit maximization on business units that might not have sufficient expertise in its early stages.
- *Structured Finance* - As noted, bank regulators and the SEC are in the process of finalizing guidance to protect against the legal, reputational and other risks in complex structured transactions. The Freddie Mac special examination indicated that this GSE in fact engaged in a wide range of structured deals without clear business purpose other than tax, earnings reporting or capital arbitrage. GSEs should not, for example, be allowed through structured transactions to transfer risk to untested

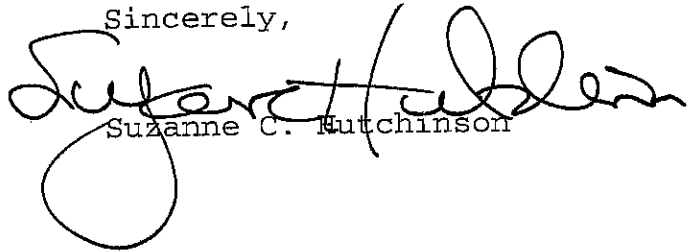
⁸ *Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*, Advance Notice of Proposed Rulemaking, Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (68 *Federal Register* 45,899) (August 4, 2003).

counterparties in a fashion not made clear to the market or to OFHEO; and

- *Conflict of Interest Standards* - Although the GSEs do not have affiliates, they operate in the market with such dominance that vendors can exercise undue influence over an entity. Rules are necessary to ensure true arm's-length relationships between GSEs and outside parties. To the degree that an Enterprise transfers its benefits to outsiders, it poses the same risk of concern to Congress and addressed in Sections 23A and 23B of the Federal Reserve Act that protect insured depositories from affiliated third-party actions; (12 U.S.C. §§ 371c and 371c-1)

~~MICA would be pleased to provide assistance on any of the noted above.~~

Sincerely,



Suzanne C. Hutchinson