March 8, 2000

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

Re: Notice of Proposed Rulemaking: Risk-Based Capital (RIN 2550-AA02)

Dear Mr. Pollard:

On behalf of the 200,000 members of the National Association of Home Builders (NAHB), I appreciate the opportunity to comment on the Office of Federal Housing Enterprise Oversight's (OFHEO) notice of proposed rulemaking (NPR) pertaining to the development of risk-based capital (RBC) regulations for Fannie Mae and Freddie Mac (collectively, the Enterprises).

Many of the provisions of the proposed RBC rule address technical aspects of the stress test model that are impossible to evaluate without access to the data, operational and accounting systems of the Enterprises. Therefore, NAHB is not in a position to provide detailed comments or recommendations in these areas. Our comments focus primarily on the principles of the RBC regulatory process and the treatment of new Enterprise products and activities.

NAHB Supports A Risk-Based Capital Standard For The Enterprises

NAHB supports the RBC requirement. Unlike bank and thrift capital standards, which are characterized by a limited number of risk-based capital percentages applied to broad asset categories, the RBC requirements that OFHEO is statutorily required to develop can be tailored in a very detailed way to the specific risks of the two Enterprises. Indeed, the stress test approach is unique in financial regulation. Further, this stress test approach is dynamic and can adjust to changes in the economic environment and the Enterprises' business practices.

NAHB appreciates the time and effort that OFHEO has devoted to developing capital standards for Fannie Mae and Freddie Mac. We support OFHEO's efforts to develop the RBC standard and commend the openness with which OFHEO is conducting the rulemaking process. In particular, we appreciate the willingness of OFHEO staff to discuss development of the rule with staff at NAHB and other industry groups.

Capital Standards Must Accurately Reflect Risk

The purpose of OFHEO's risk-based capital standard is to tie capital to the Enterprises' exposure to credit and interest-rate risk, with an add-on for management and operations risk. At its core, the question of adequate capitalization hinges on an accurate measurement of risk. A risk-based capital standard definitely is a powerful regulatory tool and, if not properly structured and implemented, could have unintended consequences for the operations of the Enterprises as well as the housing finance markets they serve.

Fannie Mae and Freddie Mac are critical components of the U.S. housing finance system. They have developed a vibrant and liquid secondary market that has ensured the availability of housing credit at affordable rates, even in difficult financial market conditions. NAHB is concerned that overly stringent capital requirements could result in higher costs of credit and a reduction in the range of products purchased by the Enterprises.

We are particularly concerned about potential adverse impacts on the cost and availability of mortgage financing for those currently underserved by the mortgage market. Such a consequence would significantly impair the Enterprises' ability to fulfill their Congressionally mandated housing mission and meet their affordable housing goals.

Fannie Mae And Freddie Mac Must Be Able To Use The RBC Model In Their Operations

We understand that both Enterprises have attempted to replicate OFHEO's stress test model in an effort to fully assess the impact of the proposal on their businesses and the housing market. We have learned that each firm has replicated the behavioral components of OFHEO's model, but have been unable to duplicate the components of the model that govern how OFHEO uses the Enterprises' data inputs as well as the cash flow and financial reports generated by the behavioral models. Obviously, for the RBC regulation to be effective, the Enterprises must be able to anticipate the amount of capital required and to incorporate capital planning into their business decisions and processes. We have received assurances from OFHEO officials that the Enterprises will have the ability to replicate OFHEO's model, and thus estimate their required capital level, before the regulation becomes final. We strongly urge OFHEO to continue to work with the Enterprises toward this end.

OFHEO Should Work Closely With The Enterprises To Address Technical Changes In The Model

As mentioned above, NAHB does not have access to the Enterprises' data and other information required to independently analyze the proposed stress test model. We have been informed by the Enterprises that, in the course of their analysis, they have identified several areas where OFHEO's model fails to appropriately measure the actual risk associated with certain Enterprise activities. As noted above, the failure to accurately measure risk, and to appropriately tie capital to risk, could result in unintended negative consequences for the cost and availability of housing credit.

Some of the key areas of concern that NAHB shares with the Enterprises include:

- Single-Family Defaults and Severity of Losses: The single-family default and severity models project loss rates that could be greater than those actually experienced in the benchmark region. The effect appears to be particularly extreme for low-downpayment mortgages, which could result in unreasonably high capital requirements for such loans.

- Single-Family Prepayments: Single-family prepayments appear to be too high in the decreasing interest-rate ("down-rate") scenario and may not be reflective of the benchmark experience. Conversely, prepayments appear to be too low in the increasing interest-rate ("up-rate") scenario.

- Treatment of Home Price Inflation in High-Rate Environments: The level of house-price inflation in the up-rate stress test appears to be significantly understated, which could result in an overstatement of defaults and credit losses.

- Treatment of Multifamily Loans: The multifamily models do not appear to appropriately capture the risk in these mortgages. The models are derived from very limited data and may not accurately reflect actual debt service coverage and prepayments under yield maintenance agreements.

- Counterparty Haircuts: OFHEO's proposed haircuts for counterparty credit risk seem excessive. Such stringent treatment could discourage the Enterprises from engaging in risk-reducing strategies with a broad array of counterparties, including certain private mortgage insurers, state housing finance agencies, seller/servicers participating in recourse arrangements, multifamily lenders participating in risk-sharing agreements, derivative counterparties, and private mortgage securities issuers. Ultimately, this could result in higher housing costs, particularly in the affordable housing market.

The Enterprises will be submitting detailed suggestions on how to correct for risk-measurement problems in these areas. We encourage OFHEO to work with the Enterprises to resolve these problems and avoid any inappropriate negative impacts on the housing finance system.

A Safe Harbor Provision Is Needed For New Enterprise Products And Activities

Fannie Mae and Freddie Mac have been at the forefront of housing finance innovation. The Enterprises have developed creative mortgage products, securities instruments and risk management strategies that have significantly lowered mortgage costs and improved housing opportunities. NAHB has worked with both Enterprises to develop a variety of new products, including a construction-to-permanent mortgage program designed to increase the availability of construction financing and lower mortgage costs for home buyers. NAHB is concerned that OFHEO's proposed treatment of new Enterprise products and activities could stifle development of such new initiatives, to the detriment of the housing finance system.

OFHEO proposes to incorporate new Enterprise activities into the stress test by simulating their credit and cash flow characteristics, using existing combinations or adaptations of the behavioral models outlined in the proposed rule. Procedurally, Fannie Mae or Freddie Mac would be required to provide OFHEO complete data and full explanations of the new activity before it is implemented, and OFHEO would simulate the new activity in the stress test and provide the Enterprise with its estimated capital treatment "as soon as possible." The proposed rule also states that "where there is no reasonable approach using existing combinations or adaptations within the timeframe for computing a quarterly capital calculation, the stress test will employ an appropriately conservative treatment . . . Such treatment will continue until such time as sufficient information is made available to justify an alternative treatment."

While it may be possible to determine capital requirements for some new products and activities in a relatively short period under the proposed approach, NAHB is concerned that capital assessments for many new initiatives may require extended implementation delays that could inhibit further innovation. In addition, NAHB believes that the "conservative" approach on proposed products and activities that are not readily incorporated into the OFHEO model could retard the Enterprises' development of new financing ideas.

NAHB feels that the best solution for addressing capital requirements for all new products and activities would be for OFHEO to provide a "safe harbor" that would allow Fannie Mae and Freddie Mac to determine the capital treatment of a new activity on an interim basis until OFHEO can fully model and incorporate the activity into their stress test. Under the safe harbor approach, the Enterprises would be required to reasonably apply, adapt, or combine the regulation's approaches, historical information and industry best practices in their determination of the interim capital treatment, while OFHEO would review the Enterprises' approach for reasonableness.

Conclusion

NAHB strongly supports a well-designed and carefully implemented risk-based capital standard for Fannie Mae and Freddie Mac. We commend OFHEO for its efforts to develop the innovative and dynamic RBC standard mandated by the Federal Housing Enterprises Safety and Soundness Act. NAHB is concerned, however, that the proposed rule could have unintended adverse consequences for the cost and availability of some forms of housing finance and could stifle innovations by the Enterprises. We urge OFHEO to provide a safe harbor provision for new products and activities. We also encourage OFHEO to work with Fannie Mae and Freddie Mac to revise some of the technical elements of the rule and to develop a workable regulation that will ensure the safety and soundness of the Enterprises, allow them to fulfill their housing missions, and foster innovation in a dynamic housing finance system.

Very truly yours,

[signed: Thomas M. Downs]

Thomas M. Downs
Executive Vice President and
Chief Executive Officer

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