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Joseph Pigg
Senior Counsel
Center for Community Development

1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5480
Fax: (202) 663-7541
E-mail: Jpigg@aba.com

March 10, 2000

Mr. Alfred Pollard
General Counsel
Office of General Counsel
Office of Federal Housing Enterprise Oversight
17006 Street, NW, Fourth Floor
Washington, D.C. 20552

Re: 12 CFR Part 1270, RIN 2550 AAO2: Notic e of Proposed Rulemaking with respect to Risk-Based Capital Stress Test; 64 *Federal Register* 18084, April 13, 1999

Dear Mr. Pollard:

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Office of Federal Housing Enterprise Oversight (OFHEO) to develop a capital requirement within specific guidelines for the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC). The legislative mandate specifies a stress test that requires these agencies to maintain sufficient capital to survive a decade of credit and interest rate shocks. The American Bankers Association (ABA) appreciates this opportunity to react to that proposal.

ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Our membership, which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks, makes ABA the largest banking trade association in the country.

The proposed rule is of particular interest to ABA in that we represent most of the institutions that use the services of FNMA and FHLMC. We have reviewed the proposal and presented discussion below from a perspective of promoting the safety, soundness and effectiveness of FNMA and FHLMC in fulfilling their charter missions: helping our members finance home ownership.

ABA makes the following recommendations with respect to the proposal:

- A definition of the range of activities of FNMA and FHLMC is needed. Capital standards are unavoidably incomplete without this definition.

- The capital standard stress test needs to be sufficiently transparent as to be readily implementable.
- A process needs to be specified for adaptation of the capital standards for changes in FNMA and FHLMC activities.
- Certain specifics of the proposal could be adjusted to make it more accurate, including
  - using a moving average of the housing price index,
  - eliminating the difference in recognition of the value of hedging using derivatives and third party guarantees,
  - updating estimates of prepayment rates,
  - not assuming that operating expenses will decline when interest rates drop,
  - stress testing on 200, 400 and 600 basis point interest rate shifts, and
  - projecting non-Treasury rates based on a ratio or spread over Treasury rates of corresponding duration.
- The capital standards for FNMA and FHLMC and the risk-based capital standards for banks should be coordinated to promote competition in the provision of financing for homeowners.

Discussion of these points follows.

Definition of Scope of Business for FNMA and FHLMC

Given the tendency to expand activities in reaction to evolution of the economic and financial landscape, capital standards cannot be complete without a definition of the activities of FNMA and FHLMC which the standards are intended to cover.

FNMA and FHLMC perform an important service in promoting home ownership in America. By purchasing home mortgages from the banks, thrift institutions and mortgage companies that originate them, then either holding these mortgages in portfolio or securitizing them, FNMA and FHLMC facilitate these institutions home mortgage financing activities. ABA recommends that the proposed stress test be developed within the guidelines of the statute so as to facilitate and not impede this primary mission.

The quasi-governmental status of FNMA and FHLMC provides them with significant advantages in raising funds in the capital markets. The careful balance between the primary mortgage market and the secondary market fostered by FNMA and FHLMC must not be disrupted. The advantages provided to them through their government sponsored enterprise (GSE) status must never be used to discourage or inhibit competition from private companies, and must, instead, be used to further stability and affordability in the American mortgage market. To do otherwise would disrupt the mortgage market and could impact the safety and soundness of both the GSEs and the institutions they serve.

FNMA and FHLMC should remain within the boundaries set by their charters. The loan-to-value ratio of the loans they purchase should not exceed 80 percent (with exceptions not inconsistent with their federal charters) and any expansion into the sub-prime market should be carefully monitored, limited in scope, and consistent with charter limitations.

The mission regulator of FNMA and FHLMC requires the GSEs to "lead the market" in developing products to serve low-income and under-served markets. The GSEs' charters recognize that activities undertaken to serve these markets may provide an economic return that is less than that earned on other activities. Therefore, the safety and soundness regulations should consider the charters' lower return expectations for sub-prime activities, the potential for greater risk posed by some of those activities, and should limit the USEs' sub-prime activities to constrain the risks undertaken.

Additionally, the capital requirements for FNMA and FHLMC should reflect their specific financial risks. The capital requirements should be consistent with the requirements for other federally regulated entities with similar risk profiles. They should at all times take into consideration the unique exposure of the public resulting from FNMA's and FHLMC's quasi-governmental status.

The Stress Test Needs to be Transparent

FNMA and FHLMC should be able to readily ascertain their capital requirements. Otherwise uncertainty can lead to high and unproductive administrative expenses and can limit product offerings. It is equally important that the stress test be transparent to the financial markets so that they can apply market discipline. The challenges that FNMA and FHLMC have had in simulating the stress test suggests that the proposed standards have not been sufficiently clear. ABA recommends that the capital standards should be as simple and transparent as possible while still assuring the safety and soundness of FNMA and FHLMC.

The proposal deals exclusively with the present basket of activities for FNMA and FHLMC. However, these agencies will evolve and adapt to changes in the economy, financial markets and technology. ABA recommends that OFHEO should develop a prescribed process for establishing the capital treatment for new activities carried out by the agencies. Laying out the process beforehand can make the standards more transparent for the future.

Recommended Changes in the Specifications to Better Reflect Risk Exposure

ABA recommends several changes to help the stress test better reflect risk exposure.

House Price Bubbles

The proposed rule requires FNMA and FHLMC to hold more capital as the loan-to-value (LTV) ratio of a mortgage loan rises. Market values of houses are determined by applying the general inflation rate from OFHEO's housing price index to previously appraised values. This approach can exacerbate speculative bubbles in housing prices and undercapitalize FNMA and FHLMC in these cases.

A decline in home prices in a region is frequently preceded by a run-up in home prices. When such a bubble occurs, application of the housing price index will lead to declining LTVs, and therefore lower capital requirements for mortgage loans. The bigger a housing price bubble, the more capital this process will release to finance further bidding up of home prices. This process can encourage FNMA and FHLMC to expand exposure in over-inflating markets, exacerbating the problem for themselves and the markets.

To avoid this problem, ABA recommends that a two-year moving average be applied to the housing price index. This will dampen the overestimation of sustainable run-up in prices during a bubble. Yet if home prices grow at a long-term stable pace then a moving average would not impact the model. Therefore this approach will cause minimal disruption in the case of normal price increases but act as a break to ensure prudential standards during inflationary bubbles.

Guarantees *versus* Derivatives

The stress test recognizes that credit risk exposure can be reduced by third party guarantees and derivatives; it reduces capital requirements accordingly. However the credit allotted is reduced as time progresses into the stress test period (assuming that the hedge counterparties' status could deteriorate over time).

At issue is the fact that the proposed reductions are ten times larger for third party guarantees as for derivative counterparties. This difference would drive FNMA and FHLMC to a more limited assortment of derivatives counterparties, and away from the much broader number of third party guarantors. As a result, the value of protection would be undermined and the consequences of failure of one derivative counterparty more severe.

This difference is certainly not justified, especially for financial institution guarantors that are strictly regulated and supervised by a multiplicity of federal and state regulators. ABA recommends that it be eliminated.

Operating Expenses when Interest Rates Decline

The stress test model assumes that FNMA and FHLMC operating expenses will decline in a future declining rate environment. This may not be a reasonable assumption.

The model links operating expenses to the size of the loan portfolio. In a declining rate environment, refinancings are projected to reduce the loan portfolio and thus operating expenses. However, operating expenses are normally linked to defaults as well as loan balances. In the not-unlikely scenario that rates decline during an economic recession, defaults and thus operating expenses can actually rise.

ABA recommends that the stress test should either model the joint relationship between operating expenses, portfolio size and defaults, or else assume that operating expenses will not decline in a declining rate scenano.

Single-Family Prepayments

A strength and also weakness of any model is that it is based on historical experience. Weakness arises when there is reason to believe that the future will not resemble the past. Such is the case for single-family prepayments. Rapid improvements in technology have brought down the cost and inconvenience of re-writing and prepaying mortgages. As a result, prepayments can be expected to be increasingly more frequent in the future, and the stress test historical parameters will underestimate prepayments. OFHEO should correct for this underestimation.

Interest Rate Scenarios

The proposed stress test requires FNMA and FHLMC to hold capital against very large interest rate shifts: 600 basis points up or down. It does not, however, require protection against smaller degrees of change. Some hedging techniques would protect against large rate shifts, but not smaller ones — *e.g.,* inexpensive, way-out-of-the-money options. ABA recommends that the stress test be augmented to include rate shifts of plus and minus 200 and 400 basis points.

Interest Rate Generation

The proposed rule suggests a process of generating non-Treasury interest rates that adds an unnecessary, and probably counterproductive, degree of complexity and uncertainty to the stress test.

Under the proposal, all non-Treasury rates would be generated using Autoregressive Integrated Moving Average (ARIMA) models. The models would be updated periodically based on new interest rate data. To achieve a degree of consistency, however, the form of each ARIMA model would be maintained over time and only the model parameters would be updated.

However, parameters estimated in ARIMA models can change substantially with updated input data. As a result, the amount of proscribed capital can change dramatically over time — with little change in the portfolio.

To avoid this instability, ABA recommends that non-Treasury rates should be calculated as a ratio or spread to a Treasury rate of corresponding duration (based on historical data). This process would still be based on the structural dynamics between Treasury and non-Treasury rates but would maintain greater consistency across users and different time periods. However, it may be appropriate to use a more complex process for certain non-Treasury rates, such as COFI.

Coordination of OFHEO and Basel Committee Capital Standards

By convenient coincidence, the capital standard for FNMA and FHLMC is being developed at the same time as bank risk-based capital standards are being revised by the Committee on Banking Supervision of the Bank for International Settlements (BIS). These standards were developed by the regulators from the largest industrial nations, but have subsequently been adopted for virtually all banks in the world. OFHEO should build on the decade of BIS experience with risk-based capital standards. Since FNMA and FHLMC participate actively in banking markets, the BIS standards should be equally relevant to these agencies. To the extent that banks, FNMA and FHLMC compete directly in the provision of financial products, OFHEO should coordinate with the BIS process so that no player is afforded a competitive advantage in capital charges.

We appreciate this opportunity to comment. We recognize that OFHEO is likely to receive many comments on this proposal, and will need time to evaluate them. Nonetheless, we encourage the enactment of a final rule as quickly as possible. The safe and sound operation of FNMA and FHLMC is of vital importance to the banking industry, the U.S. housing market, and the American taxpayer. Implementation of an effective supervisory structure is vital.

In closing, ABA supports OFHEO's proposal with these suggested modifications, and requests that an amended rule be adopted as soon as possible. If there are any questions about this comment, please call me at 202/663-5480 or Robert Strand at 202/663-5350.

Sincerely,

[signed: Joseph Pigg]

Joseph Pigg
Senior Counsel