

March 10, 2000

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

Re: Risk-Based Capital
64 Fed. Reg. 18084 (April 13, 1999)

Dear Mr. Pollard:

America's Community Bankers (ACB) is pleased to offer its comments on the risk-based capital proposal issued by the Office of Federal Housing Enterprise Oversight (OFHEO). Key components of the business of ACB members are the products that support residential mortgage finance. Thus the activities of Fannie Mae and Freddie Mac, the government sponsored entities (GSEs) regulated by OFHEO, are of great consequence to ACB members. ACB represents the nation's community banks of all charter types and sizes. Our members pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities.

ACB generally supports the proposal. While we make several suggestions for changes, ACB commends the efforts of OFHEO in bringing this complicated task of 'regulatory engineering' to its final stages. The complexity of the statutory specifications for the risk-based capital requirement to be applied to the two GSEs supervised by OFHEO have made the development of the implementing regulations a long process.

Major Areas Addressed by ACB Comment

The following topics are addressed in the comments below:

- 1) expansion of the capitalization standard to enable the risks from new lines of business to be taken into account;
- 2) greater transparency in the modeling process;
- 3) further fine tuning of the treatment of prepayment and house price behavior;
- 4) adjustments to counterparty risk haircuts;

- 5) interim simplification of the treatment of multi-family exposures; and
- 6) modifications to enterprise debt and other spreads to the Treasury yield curve and to the implicit funding strategies of the GSEs in the stress period.

Impact on New Lines of Business

The GSEs have begun to enter lines of business apart from their traditional dealings in high quality first lien mortgage loans. While it is a matter for the Secretary of HUD to determine the 'mission appropriateness' of such activities, it is OFHEO's responsibility to examine the associated recalibration of the credit-risk component of the risk-based capital requirements for these positions. The new lines that are being contemplated include: alternative-A; A-minus; subprime; and both open-and close-end second liens.

Though this is not strictly a matter for OFHEO consideration, there is an issue of the congruence of these new lines of business with the mission of the GSEs. Certainly, there are aspects of these markets that are consistent with the mission and goals of the GSEs. However, the attractiveness or viability of such markets does not suggest that they are 'mission appropriate'. ACB urges the mission and safety-and-soundness regulators to have a joint discussion and examination of such GSE activities.

One of the major underwriting tools for these new lines is the expanded use of credit histories and Fair-Isaacs (FICO) credit scores (or other such 'summary statistic' credit scores generated from debt service experience and other borrower characteristics). Automated tools have recently become standard in the private mortgage and consumer credit markets. The extensive database of GSE-purchased loan characteristics on which the entire risk-based regime developed by OFHEO is predicated does not contain these credit scores and other related data. These components enter indirectly through the LTV and other borrower/loan characteristics that are included in and collected from the loan files. If the characteristics of the 'marginal', go-forward book of business are not consistent with the prior book of business, the OFHEO model could be significantly misspecified for such new business. If more than *de minimis* in amount, this could be a serious and growing weakness.

HUD and OFHEO should consider the policy issues involved before the involvement in new business lines is undertaken. It would be unfair to impose a large retroactive added capital charge. Equivalently, however, the capital regime should address the differential risks involved with some specificity. In a sense, this would be the capital equivalent of advance program review, not with the purpose of deterring innovation, but to avoid unfair retroactive impositions. The GSEs should be permitted full exercise of their ingenuity in the credit markets where it is deemed appropriate that they operate.

ACB views this as a strategic issue that could ultimately be more significant than many others addressed in this letter. ACB also appreciates that there is no simple way for the underlying model to be updated to capture this aspect of evolving GSE operations.

ACB suggests that OFHEO request from the GSEs specific projections of the delinquency and default rates on such new products for each vintage/cohort of the items purchased. Any excess losses in these projections should be calibrated to the losses otherwise projected according to the OFHEO risk model and a risk-equivalent synthetic asset created, with an appropriate adjustment (either multiplicative or additive, as OFHEO sees fit) to the regular risk-based capital charge. The subsequent performance of these credits should be compared to these projections and an appropriate penalty factor added to the risk-based requirement in the event that the GSE projections underestimate the loss experience.

Use of a Regulatory Model

In general, ACB supports the approach taken by OFHEO in supplementing the credit risk component of the statutory stress test with the market risk, interest rate risk, and operational components of the overall risk-based approach. Because of the intricacy of the financial modeling that underlies this regulatory initiative, ACB expects that OFHEO will continue to refine the workings of the risk-based rule and its application to the GSEs. As additional data becomes available and as the guarantor and investor business of the GSEs evolves, evolution of the standard is appropriate.

As a threshold issue, ACB supports the decision to proceed with the approach of developing a 'special purpose' regulatory stress test model for application by OFHEO to each of the GSEs. This approach is consistent with the statutory language. Reliance by OFHEO on the output from proprietary internally developed risk management models run by Fannie Mae and Freddie Mac to determine the impact of the statutory stress tests could produce unequal treatment of the two entities, a result not in accordance with the statute.

If OFHEO is to develop a model to evenly calibrate the results of the two internal model runs, it might as well run the calibration model directly. Furthermore, it is possible for OFHEO to publish the specifications of its own model: this would not be possible with proprietary models developed internally by the GSEs. Publication of the model is actually required by the statute.

Release of Computer Source Code

ACB suggests that OFHEO give further consideration to the release of the actual computer code that implements the regulatory model. OFHEO has gone a considerable distance towards

an 'open source' stance by the release of the flow charts describing the interaction of the various modules of the regulatory model and the econometric equations that are being used.

In addition, OFHEO has provided a number of examples in the NPR2 Supplementary Information release of December 23, 1999. The release of these examples (notably the single-family default/prepayment simulation runs; the single-family loss severity runs; the incremental capital runs with differential loan-to-value and mortgage insurance levels; the incremental capital and funding strategies results; the derivatives worksheets; the GAAP accounting presentations; and the single-family cash-flow results) will materially assist the 'reverse engineering' efforts of interested parties.

OFHEO has expressed a concern that release of the detailed source code, together with the results of the application of the model to Fannie Mae and Freddie Mac, expressed as an actual risk-based capital requirement for each GSE as of a given quarter or year-end date, could enable other analysts to gain undue insight into the operations of the GSEs and compromise proprietary information. Such concerns have been expressed by the GSEs themselves in connection with OFHEO safety-and-soundness oversight, as well as more recently in connection with program oversight by the Department of Housing and Urban Development.

While the GSEs have been concerned about outsiders potentially obtaining proprietary information if data leaks out from the privileged exchange with regulators, there is also another concern about release of specific information caused by the unique number of entities supervised by OFHEO. There are only two GSEs to which the results of the OFHEO stress test capital model apply. Either Fannie Mae or Freddie Mac can compute that any aspect of the model or its results that are not consistent with their own data must come from the particular configuration of the other, and thereby gain undue insight into the operations of their direct competitor.

While the situation is symmetrical for Fannie Mae and Freddie Mac, there is no reason to stimulate covert financial modeling in search of proprietary information and a competitive advantage. However, release of the model source code would more likely defuse that analytical contest.

Furthermore, the danger to confidentiality is confined to release of data as regards the current competitive strategy of the two GSEs. If any detailed release of the required risk-based capital dollar amount from OFHEO applies only to data from prior years the insights, if any, into competitive positioning will be so stale in today's rapidly changing marketplace that no competitive harm is likely either from the higher level of insight available to the GSEs themselves or from the more aggregated information available to other marketplace participants. The release of the source code to the public generally would likely enable more effective supervision and more rapid error correction. Both the GSEs and other market participants

would be interested in the structure of the model and more capable of providing input that could ultimately enhance its operation and accuracy.

Guarantor vs. Investor Functions

The rest of this comment letter will focus on two separate lines of business conducted by the GSEs: their mortgage guarantor operation and their mortgage investment operation. There is no necessary connection between these lines of business. Until recently, Fannie Mae focused largely on mortgage investment, with a negligible guarantor function, while Freddie Mac focused on the guarantor side with a negligible retained portfolio. For both Fannie Mae and Freddie Mac, of late their portfolio growth rate has outstripped even the healthy growth of their guarantor business. Combined, the GSEs held \$962 billion in assets as of year-end 1999 and may have crossed the trillion dollar mark since then.

The severe stress tests applied according to the statutory specifications have less impact on the guarantor function than on the investment function. An impact is certainly present, but the results of the stress-test approach do not apparently generate capital requirements for the pure guarantor function that exceed the 0.45% minimum capital requirement from the interim capital regime that has been in place since 1992.

To apply the required stress-test calculations for credit risk to the guarantor function of the GSEs, 'all' that has to be done is to calibrate the particular characteristics of the loans underlying the mortgage-backed securities guaranteed by the GSEs (and to all mortgages and MBS owned by the GSEs plus purchase commitments outstanding) to allow for differences in LTVs and loan servicing from the benchmark loss loan cohort. Then these underlying mortgages are modeled to prepay/default over the ten year stress period and the losses computed, net of any private mortgage insurance (plus FHA-insurance, VA guarantees, and other credit enhancements), and the required level of risk-based capitalization is thereby essentially determined. There is also the 30% add-on for operational risk, although the true operational risk in the guarantor function is presumably less than for the portfolio function.

Prepayment Calibration

ACB is concerned about the details of the prepayment modeling that is the starting point for both the guarantor and investment functions of the GSEs. The reconfiguration of prepayment speeds is one of the adjustments that OFHEO is essentially forced to make to link the benchmark data to current conditions at the beginning of the stress test each time the exercise is run.

Clearly, the prepayment speeds recorded for the mortgage cohort actually comprising the benchmark loss experience must be adjusted to create the dollars in unpaid principal balance that are exposed to credit losses (and funding risk for the investment function). The prepayment functions actually estimated for use with the model if applied to that loss benchmark loan cohort would not replicate the actual prepayment speeds on those loans in either the up or down rate environment.

Though nothing in the legislative language indicates that this replication is required, the modeling should not make major changes in the time-weighted dollars at risk and then simply apply the loss rates on unpaid principal balances that were observed in that period. ACB does not regard the rote use of the prepayment speeds of that loan cohort as an essential standard for measuring the adequacy of prepayment modeling. It is important to ensure that prepayment speeds are not overestimated in the down scenario or underestimated in the up. Because everything else in the model keys off this prepayment profile modeling, any problem here spreads out into all other elements of the risk-based calculations.

This does not appear to be an issue of uncertainty in the modeling method but a case of the linkage of the prepayment and default characteristics from the joint modeling exercise that may inadvertently magnify the dollars at risk. We suggest that OFHEO consult with the GSEs and others with expertise in the area, such as the Office of Thrift Supervision which has also developed a prepayment model for regulatory purposes.

Volatility of Home Price Behavior

Modeling the evolution of house prices is the next crucial variable in the credit risk estimation process. The model structure is based on exercise of the call option on the mortgage when rates fall and the put option on the collateral property when home prices fall. ACB supports the OFHEO decision to build a measure of house price volatility into the model because it is strictly the left tail of the house price distribution that causes damage to the GSEs. Capturing an appropriate level of variation in price behavior within and between the Bureau of the Census regions that form the basic level of geographic aggregation within the model is essential.

This requires using the data from the GSE repeat sales index together with some reasonable *a priori* economic theory (or Bayesian prior statistical distributions) to achieve reasonable estimates of holding period price gains and losses. Though the actual experience of period-to-period price changes for any individual property can have any time profile, on average the variation should reflect relatively smooth behavior with the length of the holding period.

To some extent, the model should build this effect into its structure by the use of a standard stochastic diffusion process. It is not clear, however, that the actual average outcome is well behaved. Because some adjustment has been made to account for the unreliability of dispersion estimates for the long term, this may be an area where there should be some recalibration. For

example, it is not clear that the selection of the long-term cut-off point, which currently varies by Census region based on the latest data, should not be imposed on that data. There does not seem to be any reason to believe that any past realization of the variation in volatility by region will be necessarily replicated in the 10-year look-ahead of the stress period. Again, as with prepayment speeds, there is no reason to force volatility measures to be tied to the benchmark loss period in that particular geography, but equivalently there is no need to import excess levels of volatility into the calculations.

Home Price Appreciation in Up-Rate Scenario

One interrelationship from macroeconomic conditions that could also be readdressed is the deferral of any accompanying benefit from the increased home prices that would presumably be generated by an underlying inflation mechanism that might produce a sharp increase in market rates. Though there is clearly no reliable relationship between rate increases and rising home prices – indeed, in the short term, rate increases choke off home purchase transactions – property values do respond on average to inflationary pressures that are often a major component in interest rate changes. A recognition of this underlying economic linkage would be reasonable.

Low Downpayment/Low Income Loans

ACB agrees that there is no automatic connection between the income of the borrower and the LTV on the loan. The range of LTVs on loans qualifying for the low-income housing goal is about the same as for the general book of GSE business. ACB realizes that loans meeting the standards for the special affordable and the underserved geographic goals generally have higher LTVs.

The modeling methodology ensures that the propensity to default on such high LTV loans interacts in such a way as to avoid driving model results to unreasonable default levels, but it is undeniable that the underlying approach, based on default levels driven by the probability of negative equity, does penalize high LTV product. The argument advanced by some, that this effect is compounded by the default pattern in the benchmark loss cohort is an argument with the statutory specifications of the stress test. Assuming the accuracy of the selection of the particular geographic area for the cohort meeting the statutory definitions, then the default rate and the associated capital levels follow inexorably. No provision is made for regulatory discretion.

This does not necessarily mean that the GSEs will not purchase high LTV product that would count for one or more of the housing goals. If additional capital is needed to meet those goals, then some reconfiguration of the GSEs' operations can be arranged. There is express

contemplation in the statute setting the housing goal structure that some of the loans meeting these goals will not be as profitable as regular MBS. An added capital charge is the natural result of the combination of the stress test and the housing goals but, because of the dual regulatory requirements, there does not have to be any diminution in purchases of such loans.

One reason for the continued GSE purchase demand for these assets is the availability of, indeed the requirement for, mortgage insurance coverage on all high LTV loans.

Counterparty Risk Haircuts

ACB believes that the risk factors developed in the matrix for these frequency and severity levels are too stringent. The ordering across the quality ratings levels is appropriate, but the actual levels are not commensurate with the levels used by the rating agencies themselves for stress periods that are approximately equivalent to those in the prescribed scenarios. This is particularly important for the credit enhancements provided on the mortgage loans and servicing. The values used for counterparty risk in funding strategies are less significant in effect and more reasonable in amount.

The unfortunate impact may be a reduction of competition among the providers of private mortgage insurance. While such coverage is not driven completely by the treatment accorded by the GSEs, it is inevitable that any GSE preference among the purveyors of this coverage that is indirectly transmitted by the OFHEO treatment would find its way into other aspects of the PMI market. It is certainly desirable that genuine differences in the quality of the credit enhancement from various providers be reflected in the capital requirements set by OFHEO, and for that matter by depository institution regulators, but it is important that these differences be estimated in a realistic manner. ACB suggests a review of these factors.

As a modest offset to any improvement accorded on this score to mortgage insurance, ACB notes that it seems necessary to account for the lower values for the depth of the coverage of private insurance recently announced by both GSEs for new business. The treatment of the statutory provisions involving the cancellation of mortgage insurance, by computing the midpoint termination, seems to be a reasonable approach for the risk evaluation purposes of the calculations.

Other aspects of the counterparty classifications are less significant in the overall level of required capital because the extent of the credit support is considerably less. However, it should be feasible to accord some greater level of reliance to recourse or other enhancements coming from insured depository institutions as compared with other counterparties. The default treatment for such entities with strong capital positions should be at least single-A and could well

justify double-A status. For example, an insured depository subject to capital requirements, regulation and supervision should be treated differently despite being unrated.

Multifamily Default Experience

The modeling of this component of the GSEs' book of business is particularly challenging because the relatively rich and extensive dataset available for the single-family business is not present. The efforts to model the default experience in multi-family products without that data are less satisfactory.

ACB supports an alternative as an interim approach. OFHEO could obtain current data from the GSEs for the positive/negative cash flow status of the property at the beginning of the stress test and model the stress period from that point forward. As we understand, this data can be made available from the GSEs on a regular basis and OFHEO can audit the accuracy of the data supplied. There seems to be little point in modeling how the cash flow status of the property has evolved since the loan was originated if the status can be directly observed to create the correct starting point for the stress exercise.

ACB understands that the joint modeling of cash flow and positive/negative equity status has presented a challenge, given the limited data available. ACB concurs with OFHEO that both cash flow and equity have to be in negative status before the default propensity becomes significant. Again, as an interim measure, ACB could support a more simplistic approach of applying reasonable percentages to be used as an arbitrary rule against all properties with negative cash flow status to compute both default frequency and default severity for these assets.

The current approach appears to generate elements of both over and underestimation of the capital charges for these important asset types. ACB believes that logically the capital charge should always be positive, given the nature of the stress periods, rather than create a situation where the multi-family business can be a positive contributor as a hedge mechanism for the regular book of business. A richer dataset collected in the meantime and used to recalibrate the basic approach being used would enable more accurate testing of the method being used for the risk estimation. When confidence in the statistical significance of the results is higher, the modeling should revert to the more sophisticated approach that currently could be generating counterintuitive results from data inadequacies.

Impact of Overall Capital Rule

Modeling the risks of the balance sheets of the GSEs is an even more complex task because the funding strategies used by the GSEs for their mortgage and other asset holdings are intricate. It is noteworthy that the failure of Fannie Mae to meet the risk-based standard on a retroactive pro forma application to September 30, 1996 and June 30, 1997 is attributable to the lesser degree of risk immunization then accorded to the Fannie Mae balance sheet than to that of Freddie Mac.

ACB supports the distinction between the guarantor function, where the GSEs are in a dominant monopoly position for the conforming market, and the investment function, where the GSEs are major holders of MBS but do not hold a dominant share of the total MBS or mortgages outstanding. Because of the favored market position, the risk-based capital impact on the guarantor function is expected to be zero or minimal, especially because it appears likely to generate a requirement lower than that of the 0.45% capital-to-outstandings requirement.

ACB also agrees that the GSEs are using risk-based pricing on loan packages where high risk and high LTV loans predominate. Consequently, the GSEs already are receiving compensation for this risk, and any impact would apply only to the 'excess stress' in the prescribed scenarios as compared to those explicitly or implicitly being used by the GSEs.

The risk-based calculation as applied to the balance sheets of the entities is appropriately sensitive to the asset/liability make-up of these balance sheets and to the funding and market risk hedging strategies used by the GSEs. There is every reason to suppose that an application of the risk-based calculation, as amended to later balance sheet configurations of Fannie Mae, would show compliance with the risk-based requirement.

Model Stability

ACB shares the concern for 'model stability' to enable rational business and capital planning by these key secondary market participants. This is a reasonable standard. But the risk-based requirement is supposed to be dynamic, an effective tool in capturing market changes in rate levels and mortgage risk characteristics. Because of the unavoidable statutory specifications, if interest rates vary, the yield curve component of the stress test will automatically shift because each quarter it is dependent on the average value of rates over the prior nine months and on the yield curve shape as of the date from which the stress test is run.

As the book of business guaranteed or owned by the GSEs shifts, the portfolio credit risk requirement will shift too. In fact, one of the weaknesses of the OFHEO modeling may be that

it is too insensitively calibrated to catch what may already or soon will be happening to a book of business.

Relationship to Depository Institution Standards

The capitalization approach to new types of assets being purchased or guaranteed, as discussed at the beginning of this letter, may seem to be a stringent approach. However, it is what is currently happening to the capitalization required by the federal banking regulators for depository institutions engaged in such lending.

Experience in these markets has convinced ACB members that the underwriting and loan servicing procedures that are required for successful operations are significantly different from those applicable to the traditional, high-quality mortgage market. The traditional first lien focus could be seriously misleading. At any given LTV ratio -- and these ratios do not by themselves define these high-risk submarkets -- the experience in these new markets can be radically different: strenuous follow-up and collection procedures are required if loss rates are to remain under control. Servicing segregation should be required and it is a policy issue as to whether these credits should be intermingled with other traditional credits in MBS pools offered to investors. ACB also reiterates the policy issue as regards the mission appropriateness of such operations.

The statute requires a special purpose stress test approach to GSE capital that is not directly linked to the capital rules applicable to depositories. The results of the stress test generate different capital requirements from those applied to depository institutions, in some cases they are more severe and less severe in others. We do not suggest that OFHEO adopt capital rules applicable to depositories and apply them to the GSEs, however this issue of addressing new loan types does require attention from OFHEO, at the same point in time that the banking regulators are also considering a related adjustment to their separately developed risk-based and leverage rules.

ACB seeks a prudential level of capital, not a punitive level, for the GSEs but urges OFHEO to consider this dimension of risk as a priority issue as the final capital rule is being developed and implemented. In general, ACB suggests that the final rule give some indication of how new programs, many of which may share the above underwriting/data characteristics, will be treated under the risk-based rule. The GSEs and other market participants should be able to plan ahead.

ACB would suggest an equivalent approach of carefully aligning regulatory capital incentives in other areas. For simplicity's sake, in capitalizing the modest guarantor business conducted by the GSEs in the credit enhancement of REMIC and municipal issues the proposed rule applies

the regular 0.45% credit risk weight to those transactions. The rationale is that they are very modest in amount and could be complex to model. ACB concurs with the current application of the default rule of 45 basis points, but would suggest that the rule be modified to be the greater of 45 basis points or a higher number equal to the regular average credit risk weight (when that amount exceeds the 45 basis points level) times 45 basis points over the cumulative time average of the mean credit risk weights applied to each GSE for off-balance sheet activities. This would eliminate the possibility of a regulatory capital arbitrage by scaling up the required credit risk weight on such exotic, non-standard transactions when the credit risk rises above the regular 45 basis points. As long as they remain modest in amount, any impact of this revision would be negligible, but the revision would avoid the creation of any incentive to migrate guarantor business in this direction. This type of structured transaction could become more common in the future as the GSEs experiment with new loan products. The ultimate solution, if these programs do grow to a significant amount, would be to 'look through' the deal to the underlying mortgage risk, adjusted for any first or subsequent loss support provided by the originator or other counterparty.

Capitalization of the Investment Function

The OFHEO approach makes reasonable choices as regards modeling by asset grouping or by individual financial instrument for the GSE's portfolio. Given the larger range of loan types and loan vintages in the asset portfolio of the GSEs, a grouping approach by loan types, seasoning, and geography is essential. The instrument-level modeling on the liabilities side and elsewhere on the asset side is intended to enhance the accuracy of the estimate of the funding and market exposure of the GSEs for capital adequacy calculations.

To a great extent, the acceptance of the funding risk by the GSEs on their significant retained portfolios and their other asset holdings is a voluntary financial management decision. Some holdings of MBS are clearly appropriate because of the statutory purpose of the GSE to add liquidity to the mortgage market. Even so, it is clear that some of these assets are not held simply to add or maintain market liquidity.

The GSEs do have legitimate reasons for holding assets, not least of which is to earn income from the spread between their earning assets and their cost of funds. It is also clear that the GSEs have an entirely valid purpose in holding certain assets that do not have the same investment characteristics as regular MBS. The balance sheets of the GSEs can be a useful place for experimental types of mortgage-related assets that have not yet found acceptance as regular MBS. ACB members have frequently discussed the role of partially call-protected mortgages as a means of avoiding undue reliance on up-front fees to cover origination costs, a switch that can benefit both the borrower and the lender/servicer. The GSEs have purchased such product for their own portfolio, pending more responsive pricing from traditional MBS

investors for this loan feature. The GSEs have also conducted useful experiments in reverse annuity mortgages and other non-standard loan types in their asset holdings.

ACB believes that it would be a useful initial joint exercise for OFHEO and HUD's Office of Secondary Market Oversight to examine the differences between the characteristics of the retained and securitized/sold mortgage assets for both of the GSEs. Presumably the discrepancies for a given class of assets should diminish on average over time as the GSEs succeed in creating demand from other investors for the assets in securitized form. Though the carrying capacity of the GSEs is substantial, acceptance of the assets in securitized form by other investors would ensure a broader market for the underlying borrowers, with the willingness of the GSEs to support the market as a valuable back-up in the event of a temporary loss of that acceptance. This has occurred in various types of mortgage-related assets on occasion and the presence of the GSEs has been a valuable stabilizing factor.

Enterprise Debt Spreads in Stress Period

ACB supports the use of realistic spreads to the Treasury yield curve for GSE funding in the stress period. The spreads used should be related to those observable in the past for GSEs actually experiencing financial difficulties. Obvious examples are the Farm Credit System and Fannie Mae in the 1980s. The spreads used should not be calibrated to the financial difficulties being modeled in the stress period. It is clear that the perceived federal linkage keeps these spreads down from what would be observed for a fully private entity facing equivalent difficulties. It is the stress test itself that is seeking to align capital with risk. Using inappropriate spreads would create an element of 'double counting'.

Implicit Funding Strategies in Stress Period

ACB also supports modest revision to the implicit funding strategy being posited for the GSEs in funding their shrinking balance sheets in the stress period. It is certainly appropriate to avoid inadvertently according the GSEs any element of foresight in the funding mix but it is also unreasonable to assume that the GSEs could not react to the evolution of greater funding gaps in the duration of their asset/liability mix. Perhaps an approach that applies a lagged adjustment to the changes being created by the portfolio run-off corresponding to the level of mismatch in the starting position would be reasonable. This would reward matching/immunization, surely a desirable effect because the market risk on the investment function actually generates the bulk of the capital requirement.

Summary

ACB and its member institutions have been interested in the development of the risk-based capital requirements for the GSEs. The impact of the proposed requirements on the business of ACB members may not be direct, but it may be significant. To the extent that the requirements change the behavior and the business strategies of the GSEs, or the way that the market perceives the entities, all participants in the mortgage lending arena will be effected. ACB believes that the following suggestions will make compliance with the risk-based requirements more reasonable.

- The risk-based capital standard should be amended to permit the risks from new lines of business developed by the entities to be taken into account quickly.
- The model should be more transparent. ACB supports the decision to proceed with the approach of developing a ‘special purpose’ regulatory stress test model for application by OFHEO to each of the GSEs, but we suggest that OFHEO give further consideration to the release of the actual computer code that implements the regulatory model.
- The treatment of prepayment and house price behavior should be refined. It is important to ensure that prepayment speeds are not overestimated in the down scenario or underestimated in the up. Because everything else in the model keys off this prepayment profile modeling, any problem spreads into all other elements of the risk-based calculations. We suggest that OFHEO consult with the GSEs and others with expertise in the area.
- The haircuts for counterparty risks should be adjusted to take into account the capitalization and supervision of insured depository institutions. Also, ACB believes that the risk factors developed in the matrix for the frequency and severity levels are too stringent. The ordering is appropriate, but the actual levels are not commensurate with in the prescribed scenarios. This is particularly important for the credit enhancements provided on mortgage loans and servicing. The unfortunate impact may be a reduction of competition among the providers of private mortgage insurance.
- The interim treatment of multi-family exposures should be simplified. As an interim measure, ACB could support a more simplistic approach of applying reasonable percentages to be used as an arbitrary rule against all properties with negative cash flow status to compute both default frequency and default severity for these assets.
- Certain modifications should be made to the enterprise debt and other spreads to the Treasury yield curve, as well as and implicit funding strategies of the GSEs in the stress period.

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While ACB supports OFHEO in its efforts to create a manageable scheme for the GSEs, we have suggested several modifications. We will continue to review the impact on the business of ACB members and the market as the requirements are implemented.

ACB appreciates this opportunity to offer its views on this important regulatory initiative. If there are any questions about the positions taken in this submission of our views, please call me at (202) 857-5088 or Brian Smith, Director of Policy and Economic Research at (202) 857 3118.

Sincerely,

[signed: Robert R. Davis]

Robert R. Davis

Director of Government Relations