March 10, 2000

Ms. Anne Dewey, General Counsel
Office of General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W. Fourth Floor
Washington, DC 20552

Dear Ms. Dewey:

On behalf of the Center for Community Self-Help, we would respectfully like to comment on OFHEO's Notice of Proposed Rulemaking on Risk-Based Capital. We have two main concerns, to ensure that good efforts by the Enterprises to increase homeownership will not be discouraged by this rule and that harmful subprime lending practices are inherently risky and therefore should require greater risk-based capital.

I. Good efforts by the Enterprises to increase homeownership opportunities should not be discouraged

Our experience with homeownership activities generally and in partnership with Fannie Mae specifically, we believe, can help demonstrate the potentially detrimental effects of the rule on attempts across the country to increase homeownership opportunities for low-income and minority families. Self-Help, based in North Carolina, is one of the largest nonprofit community development financial institutions in the United States. Self-Help's mission is to expand wealth and ownership opportunities for all families, with a particular emphasis on groups traditionally denied access to credit: women, minorities, rural residents and low-wealth families.

For the past 16 years, Self-Help and its affiliates have aggressively sought to increase homeownership opportunities as a strategy to help low-wealth Americans take their first steps towards the middle class. While more Americans own their homes today than any time in US history, homeownership among lower income and minority families still lags significantly behind the population at large. Low-income and minority homeownership rates are approximately 45%, while the rates of high-income and white families are 86% and 72%, respectively.

We believe that the rates at which groups own homes matter because homeownership represents the best possible opportunity for disadvantaged groups to build family wealth and economic security. This need is particularly acute for minority families -- the wealth disparity between African American and white families is ten-to-one. Two-thirds of all low-income and minority family wealth is represented by the equity in their homes and the median wealth of non-elderly low-income homeowners is 12 times greater than the median wealth of similar renters with the same income.

In order to increase homeownership opportunities, Self-Help makes direct home loans to families outside of conventional guidelines through the state-regulated, federally insured Self-Help Credit Union. In addition, through a nonprofit affiliate, Self-Help funds non-conforming loans to low-income families made by larger financial institutions through Self-Help's home loan secondary market program. Also, Self-Help, develops single-family real estate for sale to low-income homebuyers and engages in targeted advocacy at the state and federal levels.

Directly and indirectly, Self-Help has financed 9,000 low-wealth homeowners with $600 million in loans. We have been financially prudent; since Self-Help started 20 years ago, it has had positive net income each year and now has assets of $540 million and a net worth of $130 million. Self-Help Credit Union is a regulated entity and received the highest possible CAMEL rating from its regulator.

We recognize the importance of financial sustainability and safety and soundness, since our impact will be short-lived without it. If our borrowers do not succeed, we have failed in our mission of creating wealth and we will have to discontinue our lending activities. Our borrowers have in fact paid us back: a testament to the viability of targeting motivated low-wealth families is that our loan losses have never exceeded 0.5% of loans outstanding in any year. We also understand the need for strong safety and soundness regulation for the Enterprises. Achieving our mission would be impossible should they become insolvent.

Self-Help's home loan secondary market program began in North Carolina in 1994. We realized that, as a small nonprofit organization, we could not reach all the low-wealth families in the state that needed access to conventional financing. At the same time, a number of lenders had originated a significant volume of non-conforming portfolio home loans in order to fulfill their Community Reinvestment Act obligations. Since these loans did not have private mortgage insurance and departed from secondary market guidelines in other ways, they were not eligible for sale to the Enterprises. As these portfolios of loans to previously untapped constituencies built up, several lenders had to discontinue CRA lending products that, to their surprise, were both in high demand and well-performing.

Self-Help's idea was to utilize the hundreds of branch offices and loan officers of the large banks to reach our target markets through purchasing these CRA mortgages. In return, the banks agreed to relend the funds to an equal number of additional families in the future. The North Carolina General Assembly provided Self-Help with the equity to take the risk on the loans.

In 1998, Fannie Mae looked at the $100 million of loans that we had purchased under the program. Fannie Mae liked how the loans performed – minimal losses and less than 2% 60-day delinquency – and who the loans were targeted to – one-third to minority borrowers, one-half to woman-headed households, 40% to rural borrowers and averaging 60% of the AMI. We proposed that Fannie Mae buy the loans from us at full-recourse, and Fannie agreed.

This model of a nonprofit CDFI intermediary selecting and taking the risk on non-conforming, high-performing loans targeted to underserved groups for Fannie Mae worked well in North Carolina. There seemed to be no reason why it might not also work nationally. So in July, 1998, Self-Help expanded its program through a partnership with Fannie Mae and the Ford Foundation. Ford agreed to grant Self-Help $50 million, the largest domestic grant in its history. Self-Help agreed to match this $50 million with $50 million of its own equity. Fannie Mae agreed that this $100 million in equity could serve as capital to underpin up to $2 billion in loans that it would buy from Self-Help, at full recourse, loans that Self-Help purchases from lenders across the country.

Self-Help warranted that it would have $100 million of net worth in hand by 2003 in order to take on the recourse risk; Self-Help already has $130 million in equity with another $20 million expected this year. Self-Help also agreed to fund a spread account that Fannie would hold equal to 1% of its present outstanding MBS balance and expected purchases for the following year. Should Self-Help default in any of its obligations, Fannie Mae takes over this account.

Under the program, Self-Help proposes to sell Fannie Mae loans that fall somewhat outside of Fannie's normal underwriting guidelines but are nonetheless prudent, although Fannie has final approval over what loans it will purchase. Through this mechanism, Fannie, Self-Help and the Ford Foundation (through an additional research project on the program) stand to learn a tremendous amount about what type of community lending works and what does not. This information will be shared with the entire mortgage finance industry. It is our understanding that our partnership is Fannie Mae's largest underwriting experiment and largest partnership with a nonprofit.

To date, Self-Help has sold Fannie Mae roughly $500 million in loans to 7,500 families. Sixty-day delinquency rates are still under 2%. Several national lenders have negotiated flow loan products targeted to underserved borrowers with us. In short, the partnership is achieving its objectives of reaching significant numbers of borrowers who otherwise would not have had access to conventional financing and providing data that will assist others in these endeavors.

Concerns about OFHEO's proposed rule

1. Innovation. We worry that OFHEO is proposing an over-bureacratized process for approving new products and new partnerships. To the best of our knowledge, our partnership's structure is unique. It came about because Self-Help had tested the program in North Carolina and was ready to undertake it, the Ford Foundation was looking at that moment to provide a large grant in furtherance of asset-building activities and Fannie Mae recognized the opportunity and acted on it. The partnership would likely not have come together if Fannie Mae had had to obtain permission from

a third party since it was highly time-sensitive; the window for Self-Help to receive the grant from Ford was a small one.

In addition, for the deal to work, we needed the lowest-possible guaranty fee that Fannie Mae could provide us. If Fannie Mae were uncertain about the amount of capital that would be required for this partnership, it would have had to build in an uncertainty premium that might have made the deal undoable for us.

It has been our experience with Fannie Mae and our observation of Freddie Mac that their innovations have increased access to the lowest-cost mortgage financing to underserved groups at very little risk. This freedom to innovate is essential to continuing to break down barriers to homeownership. We would urge OFHEO to delegate the power to innovate to the Enterprises.

2. Low downpayment mortgages. It is a truism that families with little wealth lack the funds for a large downpayment. This becomes a Catch-22 situation since families often build their wealth only by buying a home, but are unable to take this step because of their low wealth. Both Enterprises have recently recognized that low downpayment mortgages, while in some cases riskier than high downpayment mortgages, can nevertheless be made prudently.

   That has certainly been our experience, since the vast majority of the loans that we have bought have been originated at or above 97% LTV. We have found that delinquency is often higher with low-wealth borrowers since families lack a wealth cushion to draw down when inevitable emergencies arise. However, our very low loss experience speaks to the fact that correctly underwritten low-wealth borrowers tend to catch up once they fall behind in order to save their homes. They are absolutely committed to avoiding foreclosure because they realize that this modest house may be their one chance to reach the middle class and their other option is to rent at approximately the same cost; they cannot easily walk away.

   We are concerned that OFHEO's single-family default and severity models overestimate losses associated with low-downpayment loans. We want to be sure that OFHEO does not unintentionally dampen the incentives for lenders to make low-wealth and minority home loans using the necessary tool of low downpayment mortgages. We believe that the capital required for low downpayment loans could be reduced significantly without harming OFHEO's objective to ensure the safe and sound operation of the Enterprises.

3. Credit Enhancements. We are concerned that the discounting of counterparty credit enhancements would seriously hamper the ability of the Enterprises to partner with other entities to increase homeownership opportunities where needed. The rule appears to disincent the Enterprises from dealing with any counterparties because the size of the haircuts seems to be significantly greater than the risk presented.

The rule does not appear to favor risk sharing and credit enhancements. It would seem to us, however, that the Enterprises are better off and more likely to remain safe and sound if they are encouraged to share risk with other capable counterparties. We believe that risk sharing and credit enhancements create a broader group of investors who have a stake in the success of an investment and therefore improve Enterprise performance. In addition, the excess capital that the Enterprises would have to hold when counterparties take on risk could threaten the Enterprises' financial success, which is an important aspect to their safety and soundness. Finally, risk sharing and credit enhancements sometimes are the only way that a transaction can be soundly structured to support affordable housing.

The haircut for unrated entities is of particular concern to us. Because we are an unrated nonprofit, Fannie Mae would be forced to discount our full recourse credit enhancement by 80%. This would likely render our partnership unviable; one reason that it works is that Fannie is able to charge us the lowest-possible full recourse guaranty fee. Since our yield is compressed to ensure that low-income borrowers can afford their mortgages, we need this low guaranty fee for the program to function safely. If our full recourse turns out to have no capital value to Fannie, then the cost of the program to the borrower is likely to increase by an uneconomic 50 to 75 basis points of price. We think this exemplifies a broader lesson that the proper pricing due to proper capital treatment of counterparties can often mean the difference between consumers of limited means obtaining access to conventional financing and being shut out of mainstream markets.

Similarly, the rule's treatment of credit enhancements more generally is a matter of concern to us. Our 1% spread account provided Fannie Mae with the comfort and security to enter into this agreement. We warrant that we will increase the account to cover 1% of existing outstanding and one future year's of purchases. We believe that Fannie Mae should be able to count the full amount of this spread account as an effective credit enhancement that allows us to buy otherwise non-conforming loans.

We urge you to reconsider how the rule treats credit enhancements to make them a more favored practice, particularly for unrated nonprofits engaging in partnerships with the Enterprises for reinvestment purposes.

II. Harmful subprime lending practices are inherently risky and should be required to have a higher risk-based capital allocation

Homeownership not only supplies families with shelter, it also provides a way to build wealth and economic security. Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders target elderly and other vulnerable consumers (often poor or uneducated) and use an array of practices to strip the equity from their homes. Although a small percentage of mortgage brokers and lenders are responsible for these practices, the problem is large and growing (see Senator Grassley's March 1998 Aging Committee hearings: http://www.senate.gov/~aging/hr14.htm).

The Enterprises are increasingly moving into the burgeoning subprime market by purchasing subprime loans directly, guaranteeing Enterprise mortgage-backed securities backed by these loans, purchasing private label securities backed by subprime loans and "wrapping" (guaranteeing the senior portions of) such securities. Through this participation, the Enterprises have an unparalleled opportunity to reduce harmful lending practices by enforcing positive standards on the subprime industry. We wholeheartedly encourage their participation in the context of positive standards. If, however, the Enterprises simply provide greater liquidity to loans that strip equity from vulnerable consumers, then their efforts will have done far more harm than good, even if subprime interest rates fall slightly as a result of their work.

Equally important, loans that strip equity increase the likelihood that borrowers will default in greater numbers than loans that do not strip equity. Greater defaults translate into greater losses to entities that share in the risk of these loans. As a result, the Enterprises threaten their own safety and soundness when they participate in harmful loans.

Recommendations

To protect the safety and soundness of the Enterprises, we make the following recommendations:

1. <u>The Enterprises should be required to hold greater risk-based capital for harmful loans since harmful loans are inherently risky.</u> When borrowers have equity stripped away through harmful lending practices, their loans are at significant risk of default. Among harmful practices, we believe that those three described below are the most detrimental. Therefore, we believe that OFHEO should impose higher risk-based capital requirements for loans that violate any of the following criteria:

- *Credit insurance premiums should not be financed into the loan up-front in a lump-sum payment.* One type of credit insurance, credit life, is a loan product paid for by the borrower that repays the lender should the borrower die. The product can be useful when paid for on a monthly basis. When it is paid for up-front, however, it does nothing more than strip equity from homeowners. The total premiums for, typically, a five-year period are added to the amount of the loan. The borrower then pays interest on this amount for the life of the loan and hasn't even begun reducing principal by the time the five-year period expires. When the borrower moves or refinances away from a subprime loan after five years, the up-front payment, which no longer protects the loan, is stripped directly out of the borrower's home. Conventional prime loans almost never include, much less finance, credit insurance.

  Equity stripped out of a home is no longer there to provide a cushion against default. In addition, the extra interest paid on the premiums places stress on monthly income and increases the chance of foreclosure and loss. For example, a not uncommon $7,500 credit insurance policy financed in the loan costs the borrower, at 16% interest, $36,300 of lost income over the 30-year term of the loan.

- *The borrower should not be charged fees greater than 3% of the loan amount (4% for FHA or VA loans).* Charges greater than this amount for up-front fees, points, broker compensation, or other charges (not including escrows collected at closing for appraisal, attorney, credit report, and other fees paid to third parties) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay, at most, a 1% origination fee.

  High fees similarly strip equity that no longer provides a cushion, and high fees that are financed in the loan use up monthly income that may be necessary for other purposes, thus increasing the risk of default.

- *Any loan that has an interest rate that is higher than the Enterprise contract rate should not include prepayment penalties.* The subprime sector serves an important role for borrowers who encounter temporary credit problems that prevent them from receiving low-rate conventional loans. But a borrower should never be locked into a loan that risks stripping equity from the family's home; subprime loans become harmful if they prevent borrowers from getting out of loans once credit improves. If Enterprises participate in the subprime sector, they should help provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition, and prepayment penalties are designed to prevent this from happening. People should not be penalized for trying to get out of debt.

  An additional problem with prepayment penalties is that they drive and finance harmful lending practices; they are the glue that holds unconscionable loans together. A frequent lending abuse is when brokers obtain high yield-spread premiums (a fee rebated to the broker by the lender in exchange for the lender receiving a higher interest rate than the borrower otherwise qualifies for). The lender will only pay these excessive YSP fees if it is sure that the same broker will not quickly "flip" the borrower into another loan with another lender to receive additional fees. The lender ensures that this does not happen by making it uneconomic for the borrower to escape the loan through requiring the prepayment penalty. And these high YSP's finance expensive and abusive marketing practices to reach the borrowers. Prohibiting prepayment penalties lets the marketplace police yield spread premiums.

  Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some 70% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California). The real reason is that conventional mortgage markets are competitive and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take.

  As a result of these factors, subprime loans with prepayment penalties are at high risk of default. The borrower cannot escape the high interest rates without having its equity stripped out, so its monthly income comes under stress. And prepayment penalties encourage brokers to make abusive loans that are often at high risk of foreclosure from the point of origination.

2. <u>In addition, the Enterprises should be required to disclose all harmful loans, defined as above, in which they participate.</u> Enterprise risk increases when wealth-stripping characteristics are attached to loans in which they participate. Therefore, in order to remain informed on the financial health of the Enterprises, the public should have access to data on these loans and the type of Enterprise participation.

In summary, we want to make sure that the proposed rule does not hamstring the work of groups across the country that depend on the Enterprises to help increase homeownership opportunities for underserved families. In addition, while much of subprime lending is sound and helpful to families trying to get back on their feet, we want to be sure that the rule recognizes the particular risks associated with harmful subprime practices.

Thank you for the opportunity to comment on the proposed risk-based capital rule.

Sincerely,
(signed by)

Martin Eakes
CEO

Eric Stein
Vice President