

March 8, 2000

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

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

Dear Mr. Pollard:

The National Association of REALTORS[®] is pleased to submit comments on the Notice of Proposed Rule (NPR) creating a risk-based capital stress test for Fannie Mae and Freddie Mac. The NATIONAL ASSOCIATION OF REALTORS[®] represents a diverse group of 750,000 real estate professionals involved in all aspects of the residential and commercial real estate businesses. REALTORS[®] whose business is concentrated in residential real estate are vitally concerned about the issues that affect the financial soundness and operational stability of the housing government-sponsored enterprises (the GSEs or the Enterprises).

Much of the proposed risk-based capital regulation deals with technical aspects of the computer model that creates the stress test. The National Association of REALTORS[®] will not make specific comments or recommendations regarding the technical computer modeling aspects of the stress test because we do not have access to the GSEs' mortgage purchases data or the operational and accounting systems of the Enterprises. Our comments will instead focus on the principles of the risk-based capital regulation and the impact the regulation may have on residential housing finance.

REALTORS[®] Support A GSE Risk-Based Capital Standard

Congress adopted the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Act) against a background of pessimism associated with the banking and thrift crisis of the late 1980s. The near collapse of the savings and loan industry provided a crisis of confidence in the strength of the financial system generally. A 1990 Treasury Department report that concluded that the two Enterprises were too thinly capitalized to meet unforeseen contingencies should

Fannie Mae or Freddie Mac fail reinforced the pessimism of the time. Congress moved to replace the Enterprises' outdated ratio-based capital standard with stronger risk-based requirements.

The 1992 Act modernized the regulatory framework for the Enterprises. The Act established the Office of Federal Housing Enterprises Oversight (OFHEO or the Agency) as the safety and soundness regulator for Fannie Mae and Freddie Mac and authorized the Agency to examine the Enterprises. The Act also set a minimum capital standard and authorized OFHEO to establish a risk-based capital standard for Fannie Mae and Freddie Mac.

OFHEO commenced its examination of the Enterprises smoothly and established clear expertise in periodically reviewing the Enterprises. The second leg of OFHEO's regulatory mission was slower in coming given the daunting task of establishing a stress test that met congressional intent and the specifics of the 1992 Act. In this last endeavor, OFHEO is an innovator. The Agency produced a risk-based capital rule that meets the statutory requirement of tying risk assessment to the unique business of Fannie Mae and Freddie Mac. REALTORS[®] congratulate the Agency on this accomplishment.

Enterprises Important to REALTORS[®]

The Enterprises have important salutary effects for the real estate industry and America's homebuyers. Fannie Mae and Freddie Mac investment in residential mortgages and guaranteeing securities backed by these loans, as mandated by Congress, facilitates the residential secondary mortgage market. The liquidity produced by the secondary market expands home ownership opportunities for Americans and reduces homeownership costs.

The financial and operational health of the GSEs substantially affects REALTORS[®] who represent homebuyers, the end-users of mortgage credit generated by the Enterprises. With innovations in the mortgage lending and products, the GSEs offer the potential to expand homeownership into underserved mortgage markets, streamline the home lending process, and provide liquidity to mortgage products that respond to mortgage lender and homeownership demands.

REALTORS[®] representing homebuyers are particularly concerned that the GSEs meet their public policy purposes of providing liquidity to residential mortgage markets and increasing the availability of mortgage credit to low- and moderate-income families. Our primary concern is that risk-based capital standards permit the GSEs to strike a balance between financially prudent risk management while meeting the demands for mortgage credit through individual business strategies. Unduly stringent risk-based capital standards should not prompt the GSEs to retreat from activities that reduce homeownership costs or stifle mortgage product innovation because the GSEs may be required to manage more risk in their portfolios and mortgage purchases.

The GSEs point with justifiable pride to the level of purchases of mortgage loans to homebuyers whose incomes are below area median levels. The Enterprises are equally as proud about the

increased purchases of mortgage loans that facilitate investment in low- and moderate-income rental properties. While there are detractors regarding the vigor with which the GSEs purchase affordable housing mortgages, there is no denying that the Enterprises consistently meet their annual goals.

Policy Issues

Congress authorized OFHEO to establish a risk-based capital test that would subject the GSEs to specified adverse credit and interest rate risk conditions and determine the capital each Enterprise would need to weather the economic stress. The proposed test is new and arguably severe when compared to risk-based capital standards for depository institutions. Given the effects of the economic conditions of the 1980s on the real estate industry and homebuyers, REALTORS[®] are vitally concerned about the implications and effects of OFHEO's proposed regulation.

REALTORS[®] primary concern is whether the stress test precisely ties capital to the actual risks the GSEs take in pursuit of their business. If the capital required is too low, there would be no assurance that the GSEs would remain sound if these companies are exposed to the severe conditions envisioned by the capital standard. If the Enterprises' required capital reserves are too high, there would be unintended restrictions on the ability of the companies to fulfill their mission of increasing the homeownership opportunities for all Americans.

NAR believes that of the two potential results of imprecisely tying capital to risk, the result of requiring too much capital has the greater potential for harming the GSEs and the homebuying public. Requiring the GSEs to retain too much capital will have the consequence of restricting the availability of low cost mortgage credit in many areas of the country. An excessively stringent capital standard may well reduce homeownership opportunities to underserved borrowers and communities.

The national homeownership rate has risen dramatically since 1995. REALTORS[®] believe strongly that the gains in homeownership in underserved communities over the last several years are a direct result of initiatives by the GSEs. A capital standard that is too high will have a deleterious effect on this segment of the population.

Effects of the Proposed Regulation

When OFHEO issues its final risk-based capital regulation the Agency will establish a capital standard that will have far-ranging impact for all involved the residential real estate transaction. Homebuyers, homebuilders, mortgage lenders, appraisers, mortgage insurers, other real estate professionals, and the Enterprises, will be interacting in new housing finance paradigm. There is an inherent need to strike a balance between capital required under the stress test and the Enterprises' capital needs to facilitate a dynamic residential secondary mortgage market. A tension exists between the risk-based capital requirements for safe and sound GSE business operations and the congressionally mandated affordable housing goals that the Enterprises must

meet annually. The Enterprises may need to take on riskier assets to meet affordable housing purchase goals while simultaneously meeting the capital requirements proposed by OFHEO.

REALTORS[®] Prefer Conservative Capital Standard. The current robust economic and business environment is the ideal time to address the capital standards for Fannie Mae and Freddie Mac. The pessimism that pervaded assumptions about the GSEs safety and soundness seems too distant for immediate concern. Yet the potential for overly aggressive risk standards creating unintended consequences, such as restricted or more expensive mortgage credit and severely eroded homeownership opportunities, should remain a concern as OFHEO moves to finalize the risk-based capital standards. REALTORS[®] would prefer that OFHEO be conservative in their capital standards. We believe that it would be much easier to raise the capital standards if experience should demonstrate they are not sufficient, than it would be to adjust them downward if they are too aggressive.

Transparency of the Proposed Capital Standard. One of the principal issues raised by the 1992 Act is the requirement that the risk-based capital standard is transparent and replicable. The GSEs, lenders, and the relevant public must be able to understand how the capital standards were established. The GSEs must be able to replicate the computer model that drives the capital requirements of the stress test. There is an innate tension created, however. That tension is this: If the regulation completely meets the test of transparency, the Enterprises' proprietary corporate data may be compromised.

Yet, the risk-based capital regulation largely meets the test of transparency given the constraints of statutory requirement and regulatory propriety. OFHEO, in extreme detail, states what it intends to measure, how it will measure it, and provides the results of its efforts. While one can question the use of specific equations or specific assumptions, OFHEO has been upfront on the complete stress test process.

Where the regulation may fail the test of transparency is in the financial modeling of the GSE cash flows. The general public and knowledgeable analysts will have difficulty in discerning how OFHEO actually performed the financial modeling of the risk-based capital requirements for the GSEs. This public lack of access to the GSE's financial data is justified, rightly, under the protection of proprietary corporate data.

Multifamily Model Needs Evaluation over Time. OFHEO has developed extremely sophisticated models of mortgage loan performance, being careful to fully disclose how they were measuring the four key components: single family default and prepayment, single family loss severity, multifamily default and prepayment, and multifamily loss severity. REALTORS[®] congratulate OFHEO for the contribution the Agency makes to modeling multifamily defaults and prepayments. Their discussion and presentation of these models is quite explicit and while extremely technical, is understandable to knowledgeable analysts in the private sector. Whereas the single-family mortgage, loan performance models pre-date the 1992 Act; OFHEO is pioneering multifamily mortgage loan performance modeling. Though these initial models of

the multifamily mortgage loan performance are extremely complicated, they may not capture the risk in these mortgages as well in their current form as they may in the future. We note that the single-family mortgage default and prepayment models changed dramatically over time, becoming more refined and statistically more accurate. Undoubtedly experience with multifamily modeling will evolve and improve much as single-family modeling progressed.

Enterprises Replicating the Model. REALTORS[®] are also concerned that the final rule does not create perverse incentives that would be inconsistent with OFHEO's objective of tie capital to risk. We urge the Agency to consider whether the Enterprises can incorporate the risk-based capital requirement into their business operations and forecast compliance. The Enterprises successfully replicated the behavioral components of the stress test model, they were unsuccessful duplicating the model components that govern how the Agency uses the Enterprises' data inputs, cash flow and financial reports generated by the behavioral models. We urge OFHEO to continue working with the Enterprises to resolve this replication problem. Clearly, the Enterprises must be able to replicate these important components of the model that estimate the required capital levels before the regulation is final.

Fannie Mae and Freddie Mac Concerns about the Regulation

REALTORS[®] understand that Fannie Mae and Freddie Mac support a well-implemented capital standard as required by the 1992 Act. The Enterprises provided detailed information to OFHEO about their respective business operations and risk management systems as the Agency developed the proposed rule. Since the proposed regulation was public, Fannie Mae and Freddie Mac worked to review and replicate the computer model that drives the capital standard. In the course of this critique the Enterprises examined the proposed regulation in detail that only they appropriately can. REALTORS[®] do not have access to the Enterprises' data to evaluate the proposed stress test independently. We anticipate, however, that the mutual desire of the Agency and the Enterprises to develop a well-constructed, fair, and operable capital standard will result in technical refinement in the rule and facilitate a final rule following the OFHEO's review of comments.

The Enterprises tell REALTORS that they will make specific recommendations to OFHEO regarding the number of areas that could affect the accurate measurement of risk. We understand that the Enterprises will recommend that OFHEO consider revisions to the proposed regulation affecting the following issues: single-family defaults and severity; single-family prepayments; house price inflation in a high interest rate environment; counterparty haircuts; non-Treasury interest-rate spreads; enterprise-only debt penalty; GSE funding with short-term debt; Enterprises operation, expenses; multifamily prepayments, defaults, and severity, stability of the regulation. We urge OFHEO to consider these recommendations from the Enterprises.

The companies have long histories of introducing innovation that reduces costs and expands markets to new homebuyers and renters. To build on this record of accomplishment, the companies must be able to anticipate the regulatory capital treatment of new activities and

products. If the capital treatment applied to new mortgage or funding instruments is uncertain, it could stifle innovation that benefits America's families.

Regulatory Revision and Updates

The GSEs have recommendations regarding the more technical issues. REALTORS[®] complement OFHEO on the willingness to work with the GSEs to make the proposed capital standard as nearly perfect as possible in the final version. This is an important stance to assure stability in the markets as the regulation goes into effect. Regulatory compliance should not force the Enterprises to shift their focus to the process of meeting capital standards, at the expense of fulfilling their missions. We would anticipate that once finalized, revisions to the risk-based capital rule would be measured and thoroughly considered.

REALTORS[®] want to take this opportunity to highlight issues that will affect future revisions to the regulation. The proposed capital regulation does not give account for the enormous impact that the GSEs' automated underwriting and credit risk management technologies will have on the mortgage lending transaction. Similarly, the role of mortgage brokerage in loan origination must be examined and factored into future revisions of the regulation.

Finally, REALTORS[®] believe that the tension between risk-based capital requirements and the GSEs affordable housing goals should be examined. We recognize that the two issues are separate, but it is clear that the desire to have the GSEs purchase even more loans that benefit low- and moderate-income homeowners will force the Enterprises to make potentially riskier loans a part of the conforming market. It seems inevitable that the GSEs must either redefine what is subprime loan quality or delve deeper into loan markets where borrowers' credit is weaker than what is generally considered acceptable.

Conclusion

The proposed regulation is an innovative achievement for what could be termed a holistic approach to measure the risk the Enterprises must meet in carrying out their federally chartered requirement to facilitate a residential secondary mortgage market. The National Association of REALTORS[®] supports OFHEO's and the Enterprises' effort move to a final risk-based capital regulation that is consistent with the law and provides Fannie Mae and Freddie Mac with a workable capital risk regulation.

Yet, it is clear that the regulatory capital standards that OFHEO proposes are innovative and a monumental accomplishment in establishing a safety and soundness measurement framework for the GSEs. The regulation is complex and perhaps not as transparent as originally desired, but considering the task, the regulation is more perfect than not. REALTORS[®] believe the stress test model reflects OFHEO's effort to protect the public funds and taxpayer investment in the secondary mortgage finance and delivery system.

The importance of accurately tying capital to risk is crucial to enabling the GSEs to continue to meet their vital mission. By measuring the economic risk associated with an enterprise business activity, OFHEO's risk-based capital regulation should closely match risk and the need for capital. We understand that the GSEs are critical of the regulation in some specific aspects on this issue and will recommend revision to certain portions of the regulation. We believe that the Enterprises, in concert with the Agency, are the best sources for reviewing and revising the technical elements of the risk-based capital model.

Though it may not be a perfect regulation, REALTORS[®] believe that the Agency is largely successful in meeting the intent 1992 Act. The rule should be move to final status as quickly as a review of comments will permit at the close of the comment period. It is our understanding that the regulated Enterprises consider the rule a good beginning. As such, we urge OFHEO to engage the Enterprises in their recommendations for revisions. The resulting regulation will certainly fulfill the promise that OFHEO and Congress intended in devising the risk-based capital standard.

Sincerely,

[signed: Lee L. Verstandig]

Lee L. Verstandig,
Senior Vice President, Government Affairs