CONSUMER MORTGAGE COALITION

January 17, 2002

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

Re: **<u>Proposed Revisions to the Risk-Based Capital Rule</u>**
(66 *Fed. Reg*. 65146, Dec. 18, 2001)

Dear Mr. Pollard:

The Consumer Mortgage Coalition ("CMC"), a trade association of leading national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its views concerning the proposed rule to modify provisions of the risk-based capital ("RBC") rule for Fannie Mae and Freddie Mac. Our comments are primarily directed to Part A of the proposed rule, dealing with changes to counterparty haircuts, and Part C, dealing with changes to yields on GSE debt.

We strongly recommend that OFHEO should (1) allow the current risk-based capital rule to take effect, (2) gain information from running its scenario analyses, (3) publish this information for all parties (not just the GSEs) to assess, and then (4) determine what types of improvement to the rule should be addressed in a subsequent rulemaking.

Summary

We wish to make the following points concerning this proposed rule:

(1) The proposed reductions in mortgage insurance haircuts will reduce Fannie Mae and Freddie Mac's capital requirements by an estimated $1.5 billion, from about $2.3 billion under the current RBC rule to $0.8 billion under the proposal. *This is a reduction of 65% compared to the current RBC rule that was just finalized in 2001.*

801 Pennsylvania Avenue, NW, Suite 625   Washington, DC 20004
PHONE: (202) 544-3550 FAX: (202) 543-1438

The proposal will also significantly reduce their capital requirements associated with derivatives, investments, and other providers of credit risk protection. We suspect that these reductions may be several billion dollars but, because OFHEO has not published the data in this rulemaking, we do not have sufficient information to form an estimate.

(2) Fannie Mae and Freddie Mac already have lower capital requirements than virtually any other financial institution in the United States. Without some compelling justification, OFHEO should be wary of reducing their capital yet further. Otherwise, the RBC rule will have no impact at all because it will require little more capital than the minimum capital levels already prescribed by statute.

(3) In this case, OFHEO has not presented any compelling justification for making yet further reductions in risk-based capital levels of the two GSEs. OFHEO attempts to justify its proposed rule by citing a variety of historical studies using different kinds of data from different companies and different time periods. Historical studies will support a wide range of assumptions. In formulating the proposal, OFHEO should have considered the impact on GSE capital in the context of the rule in conjunction with the historical analysis. As we will discuss below, a five-year phase-in of defaults and 100% severity are more in keeping with the nature of the RBC rule, rather than the proposals made by OFHEO in the proposed rule.

(4) This rulemaking and the proposed rule itself are fundamentally flawed by the asymmetry of information available to the parties that seek to comment. OFHEO has failed to provide information to commenters about the impact of each of its proposed changes on the level of capital that will be required for the GSEs. Absent publication of that information, only two interested parties – Fannie Mae and Freddie Mac – will have access to that data since only they can run the model on real portfolios. Only the GSEs know, for example, how much the proposed rule would reduce their capital as a result of the proposed reduction in haircuts for the derivatives, investments, and other forms of credit enhancement that comprise a significant portion of their financial position.

(5) The proposed rule will have serious adverse consequences for the residential mortgage market. By favoring lower-rated counterparties, the proposed rule will create a race to the bottom. Fannie Mae and Freddie Mac will have little if any incentive to prefer "AAA" rated counterparties to those rated "AA." Moreover, because the proposed rule makes substantial cuts in the capital the GSEs must hold with respect to "A" rated counterparties, it is likely that they will move toward using "A" rated firms who could charge lower premiums due to their lower capital requirements.

(6) While reintroducing a spread for new GSE debt issuance is a positive step, the amount of the spread, 10 basis points, is seriously inadequate. In times of stress GSE debt spreads could increase significantly. A 50 basis point or greater spread increase is not unlikely. In fact, Agency spreads to Treasuries have varied by

about 70 basis points since 1998. A small spread adjustment in effect allows the GSEs to assume that they have essentially unlimited access to capital markets at preferred rates even in periods of distress. The experience of the Farm Credit System in the mid-1980s shows the fallacy of this assumption.

We respectfully make the following recommendations:

(1) OFHEO should withdraw this proposed rule and run the existing capital model to determine for itself which proposed changes might be appropriate. Running the model also may help to reduce OFHEO's dependence on the GSEs for information about the impact of possible changes to the risk-based capital rule.

(2) Once OFHEO does run the model and determines which changes to the RBC rule might be appropriate, OFHEO should include the following information with any proposed changes: (1) the impact of each proposed change on capital levels, (2) relevant data from running the model, if this is not publicly available, and (3) the identity of the parties requesting each proposed change.

(3) If OFHEO does proceed with this rulemaking, the final rule should be restructured so that the GSEs are given express incentives to use the highest-rated counterparties and to continue the GSEs' current policy of using AA or higher-rated mortgage insurance companies.

(4) Finally, if OFHEO proceeds with this rulemaking, we would make the following additional substantive comments: The default rates of the proposed rule appear reasonable. However, absent more persuasive evidence than OFHEO has been able to provide, the measure of loss severity should return to 100%, as in the current RBC rule, and the phase-in period should remain at five years, also as in the current RBC rule.

The Proposed Rule

The proposed rule would make a number of changes to the RBC rule for Fannie Mae and Freddie Mac, including changes to the haircuts for counterparty risk. In our comment letter to the Second Notice of Proposed Rulemaking (NPR2) dated March 10, 2000, we indicated that we favor evolutionary changes to the RBC rule to address changes in the economic environment and GSE activities. We also indicated that it was important that such changes be made only after careful consideration, and we further stressed the importance of not lowering any further the GSEs' capital requirements, since the RBC rule might not provide additional protection beyond the minimum capital requirements.

In our second round comment letter dated April 14, 2000, we recommended that OFHEO "maintain an appropriate level of stress when making changes to the proposed rule, and also when making later changes to the final rule." In addition, we cautioned OFHEO about making any change that would further reduce the risk-based capital requirement for the GSEs, and recommended that OFHEO should calculate the effect of any recommendation on the GSEs' current capital requirements before adopting any change.

We find those comments and cautions to be directly relevant to this proposed rule. While we understand that this is a difficult area of the RBC rule and that OFHEO has considered a number of alternative formulations, we find that the proposed changes are not an improvement, and, in fact, reduce the RBC rule’s effectiveness. Furthermore, while OFHEO may have been guided by analysis of historical losses and loss severities using a variety of data sources, we believe that the design of the RBC test should take account of the impact of the test on the capital requirements that result and the relationship of those capital requirements to other reasonable measures of capital requirements.

In particular the choices made in this section of the proposed rule will have a direct impact on the competitive features of the mortgage insurance industry and the amount of capital allocated to protecting secondary market investors from mortgage default risk. We believe that the changes to haircuts for counterparty risk should be carefully examined in the light of the opportunities that they create for regulatory arbitrage.

Historical Analysis

Counterparty risk appears to fall within the set of assumptions to be set by OFHEO in a manner to be reasonably related to the stress scenario. This directive can be interpreted in a number of ways. One interpretation would be to find the appropriate discounts to apply to cash flows from various counterparties to simulate the actual performance of these counterparties during the stress environment prescribed by statute. This appears to be the interpretation utilized by OFHEO. Based upon this interpretation, analysis of historical default levels for rated entities under a range of economic environments can form the basis for the assumption.

In using historical analysis, we believe that two key points should be kept in mind. First, historical studies that include a broad range of economic environments are preferable to those that primarily encompass strong economic conditions. Second, extrapolation to extreme market conditions should be made by looking at severe downturns or by using a mean plus standard deviation measure, rather than a multiple of the mean.

It appears that OFHEO has made a determination of the relative default rates using such an historical analysis. OFHEO appears to have reached conclusions similar to ours for the relative loss rates for variously rated companies during severe downturns. OFHEO has also appropriately noted that the highest rated companies tend to have very few losses during the first few years of an economic downturn, but then seems to have ignored that data and straight-lined the haircuts, thereby effectively giving these highest rated companies defaults in the early years even though the data does not support this conclusion.

More importantly, while the data clearly suggest that losses can rise over a ten-year time period, OFHEO should have targeted its loss analysis toward the losses that occur during the third through fifth year of the simulation. *The current proposal to phase in haircuts over a ten-year horizon essentially reduces the haircuts during periods of peak loan losses by one-third to one-half of the otherwise applicable peak amounts.*

This reduction in required capital is compounded by OFHEO's inclusion of a loss severity factor of 70 percent (or recovery factor of 30 percent). This factor also seems to result from OFHEO's consideration of historical performance of corporate bond recoveries. However, it is difficult to see how such a general historical experience could appropriately be applied to the distinct housing finance industry under the stress scenarios of the RBC rule. To the extent that the historical data may not be generally applicable, OFHEO should seek to be conservative, so as to provide for appropriate levels of capital.

While the historical analysis can support differing policy proposals, OFHEO has selected two changes that, taken together, substantially reduce the capital the GSEs must hold to account for counterparty risk. Despite this substantial impact, the historical evidence is not sufficient to show that OFHEO's choices of phase-in period and severity percentages are fair or conservative. In fact, the historical evidence does indicate that the risk to the GSEs could be substantially worse under the conditions of the stress scenarios.

The current RBC rule attempts to determine the amount of capital that the GSEs must maintain to endure serious stress scenarios. The stress test relies on cashflows from mortgage insurance companies to help cushion the impact of defaults on the GSEs. Most of those cashflows are anticipated to arrive in years 3-5 after the stress scenario begins. Thus, it is that period that deserves OFHEO's attention in considering the appropriate phase-in. To select a ten-year phase-in is to focus on the period *after* the housing sector will have undergone the stresses of most importance to the ability of the GSEs to survive. Similarly, OFHEO's assumption of a 30 percent recovery is speculative. Absent compelling supporting evidence, the 30 percent assumption runs counter to the purpose of the RBC rule, which is to assure that the GSEs in fact have enough capital to survive the stress scenarios.

Capital Requirements

The net effect of the proposed changes to the counterparty haircuts is a massive reduction in capital requirements for the GSEs, below the already low levels in the RBC rule. Reliance on the vagaries of historical analysis without regard to the resulting effect on capital can lead to a situation where the amount of capital held by the GSEs is insufficient for the risks they bear. This is clearly such a case.

The much more lenient haircuts in the proposed rule will allow the GSEs to leverage more highly their existing capital into derivatives, repurchase their own securities, and engage in other activities that do not further U.S. housing goals. This will create great risk to the GSEs' safety and soundness, as well as increase the global systemic risk exposure to these extremely large and highly leveraged institutions.

OFHEO's *Federal Register* notice did not provide an estimate of the effect on capital requirements for the GSEs under the proposed regulation. We believe that such an estimate should be included for any recommended change in risk-based capital. Based on our own internal analysis we estimate that the effect of the changes that OFHEO proposes for counterparty risk from mortgage insurance companies will be to reduce the capital requirement for the GSEs by approximately $1.5 billion versus the current requirement under the RBC rule. *This represents a reduction of 65 percent of the capital the RBC rule currently requires for mortgage insurance company counterparty risk and is approximately 3.75% of the total capital of the GSEs.*

The following table summarizes the estimate:

Impact of Haircut Changes on RBC

(billions)		
$2,500		Total Mortgage Exposure
$ 750	30%	High LTV
$ 45	6%	Stress Test Loss
$ 29	65%	Covered by MI
		Assumes 30% AAA / 70% AA
$ 2.3	7.70%	PV of haircut--RBC July 2001
$ 0.8	2.60%	PV of haircut--Proposal Dec 2001
$ 1.5	**Reduction in Capital from RBC/July 2001**	

In addition to the estimated $1.5 billion reduction in capital for mortgage insurance company risk, the proposed rule would also lead to substantial additional reductions in capital associated with counterparties other than mortgage insurance companies. For example, the proposed capital reduction also would apply to derivative positions that the GSEs hold and also to the investment securities that they hold in their portfolios. OFHEO has failed to supply data on the scope and magnitude of the changes it is proposing. The impact could amount to further reduction in capital levels of perhaps billions of dollars. At this point, only the GSEs can run the risk-based capital model because only they have access to the information that is needed. All interested parties should have access to this information to enable them to make informed recommendations, and OFHEO to make a balanced judgment.

Industry Capital

Under the proposed rule, the GSEs would rely on mortgage insurance companies to provide nearly $30 billion of cash flow during the stress scenario, but would need to hold only $800 million of capital for counterparty risk. While this outcome can be seen as OFHEO's vote of confidence in the strength of the mortgage insurance industry, the likely impact will be to reduce the capital of that industry because the GSEs will effectively be given a strong incentive to seek risk protection from lower-rated counterparties under the proposed rule.

The proposed rule reduces the amount of GSE capital required to address counterparty risk from mortgage insurance companies and also reduces the gap in capital requirements between coverage by an "AA"-rated company and "AAA" coverage. The impact of reducing this gap will be to substantially lower the amount of capital in the mortgage finance system that is available for absorbing credit losses.

The provision of mortgage finance capital for absorbing credit losses is essentially a closed system with the capital provided either by the GSE or by the mortgage insurance company. For loans where mortgage insurance is required, capital requirements will affect the GSE's choice of rating of the provider of that coverage. This is a classic setting for regulatory arbitrage.

We estimate that "AAA" mortgage insurance firms must hold about 60 to 90 basis points of additional capital over comparable "AA" firms. (Under the proposed rule, it appears that the GSEs would need to hold only 5 basis points of additional capital on new high LTV business when using a "AA" rated, versus a "AAA" rated provider. This imbalance creates a significant advantage for "AA" rated insurers that most likely would cause the "AAA" rated insurers to withdraw their "AAA" capital from the market and move to a lower "AA" standard. Thus, OFHEO is creating incentives for lower quality risk protection and a reduction of capital for the closed GSE system.

On an overall basis, if the GSEs were to switch entirely to "AA"-rated providers, or if the "AAA" providers were to reduce their capital to "AA" levels, the GSEs would be required to increase their capital by only $200 million while the mortgage insurance industry could see an estimated capital reduction of over $1.25 billion.

The proposed rule has the potential to drain capital from the housing finance system yet further. Because of its assumptions concerning the phase-in period and the loss severity rate, the proposed rule would lower the current capital that the GSEs must hold against coverage from an "A" rated counterparty to about one-third of the current requirement. This is likely to create yet further opportunities for regulatory arbitrage, if the GSEs are permitted to select "A" rated firms to provide credit risk protection.

The proposed rule also would allow the GSEs to apply "AA" haircuts for certain unrated seller/servicers that provide other forms of credit enhancement. While we have no objection to giving credit for reserve funds and other forms of credit, we recommend that such forms of credit act only as an offset against the related losses in the stressed scenario, not as a change in the probability of default.

Finally, OFHEO should revisit its proposed spread premium for new GSE debt issuance during a period of stress. Clearly, GSE spreads will widen at a time of stress. However, again, OFHEO has made assumptions that are not supported by the relevant historical evidence. The one case of failure of a stressed GSE was the Farm Credit System (FCS) in the mid-1980s. Before 1985, FCS securities were priced at only 5 to 10 basis points above Treasury securities of comparable maturity; that spread grew to 35 to 114 basis points by September 1985. In December 1986 FCS issues maturing in 1997 averaged 89 basis points above similar Treasury bonds. OFHEO's assumption of only a 10 basis point widening of spreads on GSE debt is not consistent with this historical evidence.

Conclusions

With respect to counterparty risk, OFHEO has proposed three major changes that together would reduce GSE capital by a substantial amount:

(1) a phase-in of ten years before haircuts reach their peak amounts;
(2) the introduction of a 30 percent recovery rate (or 70 percent severity rate); and
(3) a reduction in default rates attributed to "AA" rated counterparty exposures.

The first change, to extend the phase-in period for haircuts to take effect, will cut GSE capital requirements for counterparty risk roughly in half. It would be more appropriate to shorten rather than lengthen the phase in period, to more properly reflect the concentration of risk in the early years of the stress. Precisely those losses that occur in the early years of stress are the ones that would lead to the default of the stressed mortgage insurance companies.

The second major change, reducing estimated severity rates, is not backed by persuasive data. The loss severity calculation, which might be appropriate for a general corporate bond analysis, is not appropriate for such a specialized industry under the stress scenario. Given the substantial impact of this assumption in reducing the amount of capital the GSEs need to hold for counterparty risk, whether "AAA," "AA," "
less, this assumption should be rejected.

The third proposed change, OFHEO's proposed change in default rates, appears reasonable in light of the evidence presented. The proposed default rates appear to be reasonable on a relative basis, considering "AAA" ratings vis-à-vis "AA" ratings. However, these need to be reviewed over time to assure that the magnitude of the default rates is, in fact, appropriate.

Another part of the proposed rule deals with spreads on new debt issued by the GSEs during the stress period, which would lead to increased capital requirements. We recognize that OFHEO has addressed this issue as an improvement to the current rule. However, the 10 basis point add-on is inadequate compared both to historical levels of spread variability and to the FCS experience.

Recommendations

For these reasons, we urge OFHEO to withdraw the proposed rule until it has had the opportunity to run the risk-based capital model for itself. Then, if OFHEO determines that changes might be appropriate, OFHEO should publish information that enables all commenters, and not merely the GSEs, to understand the implications of each change for the level of capital that the GSEs must hold and also the assumptions that went into the analysis. By themselves, the collection of disparate studies that OFHEO has presented in the proposed rulemaking do not justify either a multibillion dollar reduction in GSE capital requirements or the adverse consequences resulting from GSE business incentives to choose low-rated counterparties, thereby draining capital from the mortgage industry.

We strongly recommend that OFHEO should (1) allow the current RBC capital rule to take effect, (2) gain information from running its own scenario analyses, (3) publish this information for all parties (not just the GSEs) to assess, and then (4) determine what types of improvement to the RBC rule should be addressed in a subsequent rulemaking.

We would close with a more general point. The recent Enron failure illustrates yet again the historical pattern that we saw with Long Term Capital Management and Continental Illinois, among others: fast-growing highly-leveraged financial institutions, and especially those that rely heavily on the newest financial innovations (here derivative securities and hedges), are especially vulnerable to failure. It is only later that regulators, the accounting profession, and others responsible for financial soundness discover the steps that they should have taken before rather than after the institution's failure. The high standing and influential positions of the leaders of these institutions are no substitute for strong capital requirements and sound financial supervision. We urge OFHEO to be cognizant of this historical pattern and its possible implications for the GSEs.

Thank you for the opportunity to submit these comments.

Sincerely yours,

Anne C. Canfield
Executive Director