
CONSUMER MORTGAGE COALITION

April 14, 2000

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

Re: Risk-Based Capital; Second Notice of Proposed Rulemaking;
Second Round of Comments

Dear Mr. Pollard:

The Consumer Mortgage Coalition, a trade association of national mortgage lenders and servicers, appreciates the opportunity to provide further comments on the Second Notice of Proposed Rulemaking (NPR2) with respect to OFHEO's implementation of the stress test component of the government sponsored enterprise (GSE) capital requirements. This comment letter will focus primarily on a review of comments submitted by Fannie Mae and Freddie Mac.

Unfortunately, due to the time allotted to the response period, and our lack of access to crucial GSE data, we are not able to provide complete conclusions about the two GSEs' recommendations. As a result we would like to put forth several principles that we believe should guide OFHEO in adopting its final rule. Our review of the comments on NPR2 has strengthened our view that OFHEO should use the current rulemaking to establish an appropriate process for evaluating the adequacy of each GSE's capital and for making subsequent modifications to the regulatory capital requirements.

The CMC urges OFHEO to consider the following issues when it adopts the final rule:

- *The stress test is limited to only two scenarios.*

Because there are only two scenarios in the model, OFHEO faces tradeoffs in selecting the terms of the final rule. Choices that increase the credit risk component of the test may serve to decrease the interest rate component. For example, slower prepayment speeds in the down rate scenario may serve to increase credit losses somewhat, but at the same time may drastically lower the cost of hedging the interest rate risk of the retained mortgages. Likewise, steeper or flatter yield curves may alter the capital requirements.

- *Given a fixed set of rules and only two stress scenarios, the GSEs have latitude to use strategies that may reduce capital requirements but not necessarily reduce risk.*

As we discussed more fully in our original comment letter, under the legislatively mandated stress test, the GSEs have latitude to use strategies to reduce capital requirements without actually lowering risk levels. Out-of-the-money options are only one of the inexpensive devices that the GSEs could use to reduce their capital requirements that would not protect against more probable but less extreme forms of risk.

- *The proposed OFHEO risk-based capital standard allows the GSEs to operate so close to the statutory minimum capital standard that the stress test is unlikely to have significant effects on GSE behavior.*

A number of commentators express concerns, sometimes attributed directly to information provided by the GSEs, that the risk-based capital rules will discourage the GSEs from serving affordable housing needs or other important segments of the housing market.

In practice, the GSEs are likely to be guided by their perception of capital costs at the margin. That margin is so close to the statutory minimum capital requirements that significant effects would seem improbable. Concerns over the two GSEs' commitment to affordable housing, so that they lead rather than lag the market in serving affordable and minority housing needs, are properly addressed to the Department of Housing and Urban Development, rather than OFHEO.

- *The capital requirements of the GSEs are lower than those of comparable financial institutions.*

The arguments made by Fannie Mae and Freddie Mac are not persuasive. For example, Freddie Mac submitted a paper by one of its consultants, Mark Flannery. That paper relies upon a number of questionable assumptions to justify its conclusions. Mr. Flannery assumes that GSEs have one-quarter of the credit risk of other depository institutions, due to the diversified nature of their portfolio. However, many depository institutions have portfolios diversified across product lines and many of the larger financial institutions have nationally diversified mortgage portfolios. Mr. Flannery also assigns income to the off-balance sheet

(OBS) activities of the GSEs (the guarantee fee) but does not allow for any fee income for banks, and does not assign any income to portfolio activity. The distortion of this assumption is accentuated by his assumption that the GSEs have an off-balance sheet mortgage portfolio that is five times as large as their on-balance sheet activities. Currently the combined OBS mortgage portfolio of the two GSEs is only one-and a half times their combined on-balance sheet portfolio.

Mr. Flannery also assumes that OFHEO could address any capital deficiency of a GSE within three months, while the regulators of depository institutions would act within a year. Even a few additional months of delay in identifying and rectifying a problem would lead to different results in his model. Recomputing the probability of default after adjusting Flannery's assumptions to more current data produces the result that the GSEs only have a lower probability of default if they are assumed to be significantly advantaged in having a much lower degree of credit risk, a much shorter evaluation time and much better interest rate risk management. That is, one can conclude that the GSEs should have a lower capital requirement only if one starts out by assuming that the GSEs have less risk.¹

Similarly, Fannie Mae cites studies by its consultants indicate that the average thrift would require 60-75% more capital if subject to a stress test comparable to the OFHEO model. Fannie Mae did not make these studies publicly available. Therefore, we are unable to address their methodology. A large, diversified financial institution would not face a significantly greater capital requirement from applying the stress test to its mortgage portfolio than would be the case for a GSE that undertakes similar activities. If given the opportunity, depository institutions would likely accept the capital requirements of the GSEs instead of the much higher leverage ratios and risk-based standards that they must meet. Moreover, any analysis of the performance of a non-GSE under the risk-based test is merely speculative because the test does not adequately address many of the assets and liabilities of banks, thrifts or other institutions.

- *Requiring that adequate levels of capital be maintained for the safety and soundness of the GSEs is not a tax on housing.*

The GSEs have stated that increased capital requirements would result in a "tax on housing."² As noted in the March 10, 2000 comment letter from GE Capital Mortgage Corporation, there need not be any linkage between capital standards and home mortgage rates. The GSEs have options to meet any increased capital requirements without raising mortgage rates. For example, the GSEs could issue

¹ These issues are addressed further in the Technical Addendum.

² "The approach OFHEO appears to have taken effectively substitutes the dictates of a regulator for the business experience and judgment of the enterprises.... This approach can drive up the cost of mortgage finance for all homebuyers. But its effect will be greatest on the low-income, minority and other special needs borrowers we serve." (Attachment to letter of Jamie S. Gorelick, Vice Chair, Fannie Mae, to Joshua Gotbaum and Donald Arbuckle, Office of Management and Budget, February 19, 1999, p. 1).

additional stock while maintaining above-market returns for their shareholders, and not increase mortgage rates at all -- especially on products that serve affordable housing needs.

As the GE Capital Mortgage letter further notes, it is fundamentally Fannie Mae and Freddie Mac's choice whether or not to increase costs for consumers. The CMC would add that if the result is that the risk-based capital requirement for one GSE does not exceed its statutory minimum capital requirement, then the other GSE would find it difficult to raise mortgage rates to consumers independently.

In light of these considerations, we would respectfully suggest the following course of action for OFHEO in issuing the final risk-based capital rule:

1. *Implement the proposed rule as soon as possible.*

The large number of comments and the range of issues raised in them could lead OFHEO to consider changes to the rule that could delay implementation. Instead, we recommend that OFHEO make changes in areas where there is broad agreement, such as recalibrating by LTV bucket, eliminating the ARIMA models, and reducing the disparity between third party and derivative haircuts, provided that such changes will not require extensive analyses or system changes which might further delay implementation of the rule.

2. *Maintain an appropriate level of stress when making changes to the proposed rule, and also when making later changes to the final rule.*

The limitations of the stress test need to be considered in making changes. Because there are only two scenarios, it is important to balance offsetting considerations. OFHEO should make model changes that create an overall balanced stress and not necessarily that provide the maximum internal consistency. For example, it may make sense to use prepayment speeds that are faster than the Benchmark Loss Experience (BLE) in order to generate appropriate interest rate stress. Also it may make sense to stress only GSE borrowing rates, even though the stress test is imposing haircuts on other financial instruments. OFHEO should utilize additional scenario analyses (as described below) to provide guidance on how to create a proper balance.

We recommend that OFHEO calculate the effect of any recommendation on the GSEs' current capital requirements before adopting any change, particularly if the change would further reduce the risk-based capital requirement for either GSE.

3. *Continue to revise and improve the OFHEO models.*

OFHEO's flexible implementation of the rule is an important to be responsive to changing conditions and/or portfolio risk characteristics. The March 10, 2000, CMC comment letter proposed a methodology for allowing changes to the rule that would promote stability while enabling improvements. It is particularly important that OFHEO vigilantly monitor the treatment of portions of the GSE business that are not currently large enough to affect the overall capital

requirement but that over time could become a more significant component to their overall risk.

4. *Establish the capability to perform scenario analysis beyond the requirements of the stress test.*

We urge OFHEO to perform additional scenario analyses on a regular basis and to publish the results. By conducting its own analysis of a wide variety of stress scenarios, OFHEO will enhance its ability to address issues such as were raised in the comments of the GSEs with respect to (1) the shape of the yield curve, (2) basis risk and the relationship of federal agency debt to Treasuries, (3) minimum prepayment speeds, (4) the home price inflation rate.

5. *Build and maintain the capacity for OFHEO to administer its own model.*

Both Fannie Mae and Freddie Mac propose that OFHEO delegate to them the responsibility to administer the risk-based capital model. Freddie Mac suggests that it could be several years before OFHEO gains the capacity to run a "production quality" information system.

OFHEO could find itself incapacitated if it takes this course. First, OFHEO needs the ability to administer the risk-based capital test in bad times as well as good. Like any regulated institution, cooperation with the institution's regulator in good times may become more reluctant in times of financial stress. OFHEO should not delegate authority to the GSEs to perform capital tests for regulatory purposes because this would interfere with OFHEO's own ability to test sensitivities and changes to its model. OFHEO could lose the capacity for independent action if the only validated systems for running a capital stress test reside at the GSEs.

Second, OFHEO may create a dynamic that might encourage the GSEs to support OFHEO's need for sufficient resources. If OFHEO relinquishes control of the risk based capital test to the GSEs, the GSEs will have no incentive to support OFHEO's need to build its capacity so that it can adequately review and regulate the GSEs.

6. *Wherever OFHEO is constrained by legislation from fully regulating the safety and soundness of the GSEs, OFHEO should make recommendations to improve the applicable law.*

If OFHEO determines that the statutory limitations of the stress test result in a lower capital requirement for the GSEs than OFHEO believes is prudent for such large institutions, then OFHEO should propose changes to the legislation. Many of the shortcomings of the proposed rule, including the complexities of the rule to which both Fannie Mae and Freddie Mac object, can be traced to flaws in the legislation that OFHEO must implement.

In addition to these comments on larger issues related to the risk-based capital rule, the CMC also would like to address some of the technical issues raised in comment letters:

We are in agreement with Fannie Mae and Freddie Mac on some of the most important issues raised:

1. recalibrate the residential mortgage loss model by LTV;
2. eliminate the ARIMA models used to forecast interest rates; and
3. level the disparity between derivative and third party haircuts.

While there are some slight differences in the recommendations, these represent broad areas of agreement. We hope that OFHEO will rapidly adopt changes in these areas and proceed with the implementation of the rule.

In other areas, Fannie Mae and Freddie Mac addressed issues that are similar to those raised by CMC. However, the GSEs proposed reducing capital requirements, while CMC recommends that OFHEO adjust the following variables to appropriately stress the GSEs:

- Yield curve shape
- Interaction of prepayments and defaults
- Refunding of debt
- Spread on new agency debt
- Adding additional variables to performance models
- Administrative expenses

For many of these issues there is no single correct approach. Therefore it would be appropriate for OFHEO to utilize sensitivity analysis in order to better understand the risk to the GSEs from these factors before implementing the changes recommended by the GSEs that would lead to reduced capital requirements.

In addition, the GSEs addressed other subjects that were not addressed in the CMC's comment letter. These include proposed adjustments to:

- The Benchmark Loss Experience (BLE);
- MBS Spreads;
- The default model, including
 - Increased inflation adjustment, and
 - Product differentiation;
- Severity calculations;
- Multifamily models
- Commitments
- Settlement of derivatives;
- The mechanism for performing model calculations; and
- The present value (PV) methodology.

While CMC has not performed extensive analysis of these recommendations, we urge OFHEO when addressing these issues to apply the principles that we have set forth above.

In conclusion, the recent experience in the capital markets adds further support to one of points made in our March 10, 2000 comment letter. Last month, Gary Gensler, Undersecretary of the Treasury for Domestic Finance, testified that Treasury supported reducing or eliminating some features of the government's implied guarantee including its line of credit to the Treasury and the exemption of the GSEs from bank investment limits. As a result, spreads on GSE debt increased significantly, indicating that the market does not believe that the GSEs have sufficient capital to sustain their current market spreads without the support of the government. The reaction in the capital markets supports our contention that OFHEO would be prudent to require more adequate capitalization for the GSEs than is currently required or would be required under the proposed rule.

The CMC thanks OFHEO for the opportunity to submit these comments and applauds OFHEO's novel process of inviting interested parties to comment on each other's submissions.

Sincerely,

Anne C. Canfield
Executive Director

Attachment: Technical Addendum

TECHNICAL ADDENDUM

Mark Flannery's model was recreated to analyze balance sheet data for Freddie Mac and Washington Mutual Bank (WaMu). The form of his model has been changed slightly by altering some of the inputs. Specifically, income was calculated by using actual equity, return-on-equity (ROE) assumptions, and dividend payment assumptions. The form of other model inputs was essentially identical to that used by Flannery. Table 1 compares the base case inputs to the model.

Table 1: Comparison of Model Inputs

	<u>Freddie Mac</u>	<u>WaMu</u>
Assets	321,421	165,493
Liabilities	varies w/ equity	varies w/ equity
Off-Balance Sheet (non-hedge)	544,920	12,696
Equity %	3.21% or 3.371%	4.28% or
5.646%		
ROE Assumption	25%	15%
Dividends Paid	25% of income	25% of income
Asset Duration	3.0 years	3.0 years
Liability Duration	2.0 years	2.0 years
Standard Deviation of Return on Liabilities	1.80%	1.80%
Standard Deviation of Default Losses	.50%	.50%
Correlation between Interest Rates and Default Losses	zero	zero
Standard Deviation of Managerial & Operations Risk	50% of income	50% of income
Time between Evaluations	1 year	1 year

For asset, liability, and off-balance sheet item balances, information was taken from Freddie Mac's and Washington Mutual's 1998 annual reports. For off-balance sheet items, hedge-related balances were subtracted, but without an adjustment to capital requirements since the capital associated with those balances is such a minor part of the total. (The CMC comment letter presents calculations of required minimum capital under OFHEO and OTS regulations.) For Freddie Mac, two equity percentages were used. The first, 3.21% of assets, was the calculated minimum leverage requirement under OFHEO regulation. Actual equity of 3.371% was also used in the analysis, which was assumed to be approximately equal to the capital needed to pass OFHEO's risk-based capital test. (Freddie Mac passed this test in June 1997.) For Washington Mutual, the calculated minimum risk-based capital and the actual capital percentages, 4.28% and 5.646% respectively, were used. The ROE assumptions were set at 25% for Freddie Mac and 15% for Washington Mutual (which is an advantage to Freddie Mac), and dividend payments were assumed to be 25% of income. All other assumptions were from the Flannery study, although they have been made equal for the initial comparison.

In running the model, it was determined that the assumptions leading to the greatest differences in default probability were the asset – liability mismatch, the standard deviation of default losses, and the time between evaluations. These assumptions were set to be initially equal to each other and then sensitivity analysis completed for each entity. These results are shown in Table 2.

Table 2: Z-Scores				
	Freddie Mac		WaMu	
	Minimum	Actual	Minimum	Actual
	Leverage	Capital	Risk-Based	Capital
	3.210%	3.371%	4.280%	5.646%
Time between Evaluations				
0.25	4.00	4.19	7.71	9.83
0.50	2.95	3.09	5.60	7.14
0.75	2.52	2.64	4.70	5.99
1.00	2.27	2.38	4.17	5.32
Std. Dev. Of Default Losses				
0.25%	3.15	3.29	4.57	5.79
0.30%	2.96	3.09	4.51	5.71
0.40%	2.59	2.71	4.35	5.53
0.50%	2.27	2.38	4.17	5.32
Duration of Asset				
2.00	2.76	2.89	8.01	9.92
2.25	2.70	2.83	7.19	8.91
2.50	2.59	2.71	6.02	7.53
2.75	2.44	2.55	4.98	6.30
3.00	2.27	2.38	4.17	5.32

Flannery produced results in the form of a probability of default computed from the ratio of capital to income variability. That ratio is essentially a z-score and we show those z-scores as opposed to the probabilities. In essence the z-score represents the number of standard deviations of risk that the institution can bear. Higher numbers indicate greater capability to bear stress. Conversion to probabilities assumes that the risks follow the “normal” distribution. For many of these risks, historical evidence does not support that assumption.

For this comparison, look at Washington Mutual’s minimum risk-based capital (which is lower than their actual capital) in comparison to Freddie Mac’s actual capital, which is assumed to equal their risk-based capital. These results are shown in the middle two columns of Table 2. For all three sensitivities, one can see that Freddie Mac is able to withstand less stress than Washington Mutual, which is expected since their capital percentage is lower. If one looks at each sensitivity individually, one can determine how much better Freddie Mac must perform in order to be able to be equally well capitalized per unit of risk (i.e., able to withstand the same amount of stress).

First, looking at the time between evaluations, the z-score calculations for the two entities are nearly equal when WaMu is evaluated once per year and Freddie Mac is evaluated quarterly. (This assumes that quarterly call reports and TB-13 tests completed by WaMu are of no value at all.) It would seem unlikely that any regulator could take dramatic action within three months of the occurrence of a risk event. In the case of OFHEO, the stress test calculations would not be completed until some time after the quarter and would not be verified until some time later. Moreover given the size of Fannie Mae and Freddie Mac, it might be additional time until any significant changes could be implemented.

In the standard deviation of default loss analysis, one can see that at no smaller standard deviation of default losses is Freddie Mac able to withstand the same amount of stress as WaMu. In fact, even if the standard deviation is set to zero, the z-score increases only to 3.96, still less than the 4.17 calculated for WaMu. (Note that it is highly unlikely that the standard deviation of default losses for a regional bank is 4 times that of Freddie Mac as proposed by Mr. Flannery.)

Finally, in the sensitivity analysis for asset – liability mismatch, the duration of the asset in comparison to the 2-year duration of the liability has been changed. Again, at no point is Freddie Mac able to withstand the same amount of stress as WaMu. In fact, it is necessary to increase WaMu's mismatch by increasing the asset duration to 4.04 years to get the same z-score as Freddie Mac with an asset duration of 3 years. Thus, WaMu can withstand a year greater mismatch and have the same default probability.