

January 17, 2002

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

RE: Proposed Revisions to Risk-Based Capital Rule

Dear Mr. Pollard:

FM Watch is pleased hereby to provide the Office of Federal Housing Enterprise Oversight (OFHEO) with comments on the proposed revisions to the risk-based capital rules governing Fannie Mae and Freddie Mac ("the GSEs"). As an organization of leading trade associations in mortgage finance and mortgage insurance, as well as of associations representing the financial services industry more broadly, FM Watch is committed to ensuring that the GSEs operate in a safe and sound fashion that promotes their continuing ability to support the growth of American home ownership.

Unfortunately, FM Watch must express considerable concern over the proposed revisions to the risk-based capital (RBC) rules. These in part relate to the proposal itself and in part to the underlying RBC regime created in the final rules released by OFHEO on July 19, 2001. Our comments are summarized as follows:

- We believe that it is essential for the GSE capital rules to increase capital to the levels required by bank regulators for comparable risk. Only comparable capital will ensure the GSEs' ability to continue to operate during the stress periods in which they are essential. The GSEs were given numerous government benefits to allow them to operate at times in which truly private companies may be under so much pressure that their ability to purchase mortgages is endangered. Lax capital rules during good times endanger the GSEs' ability to continue to support American home ownership during the tough ones, thus undermining their Congressional mandate and mission.
- The rule should not permit cross subsidization between credit and interest rate risk.

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- OFHEO should treat GSE debt during the stress period stringently to minimize taxpayer risk.
- GSE regulatory capital determinations should conform with those required under Generally-Accepted Accounting Principles to ensure that rapid changes in equity related to derivative valuation do not adversely affect regulatory capital.
- The proposed rules exacerbate a problem in the final ones that would create a strong incentive for the GSEs to take on risk in multifamily housing projects that play no role in promoting affordable housing.

Our comments are also based on the difficulty evaluating the RBC standards. FM Watch urges OFHEO quickly to respond to Chairman Baker and provide the public with quantitative impact assessments of the new capital rules, as well as of this proposal. Without any assessment of the impact of these changes, it is difficult to determine whether they promote our over-arching goal of ensuring GSE solvency. We question OFHEO's ability to craft appropriate capital regulation without this quantitative impact information, and urge you to release it to let the public know that these RBC rules have been crafted with a good understanding of their impact on the GSEs and on U.S. housing more generally. Until this date is released, we urge OFHEO to make no further revisions to the pending final rule.

1. The Overall OFHEO Framework Remains Too Lax

FM Watch believes that it is essential for the GSEs to operate at RBC and leverage standards that approximate to the greatest degree possible the rules governing insured depositories and their holding companies. We recognize that OFHEO's governing statute to some degree limits its ability to craft forward-looking RBC rules that take advantage of current developments in international bank capital standards. However, we think it essential for OFHEO rules to follow the U.S. and Basel standards as closely as possible. This would ensure not only that the GSEs operate at prudent capital ratios, but also that the GSEs are not granted any regulatory arbitrage opportunities by virtue of idiosyncrasies in their capital regulation.

It is not possible in this comment to go into detail on the many ways in which the final RBC rule and this proposed one differ to their disadvantage from bank capital rules. However, we note as just one example the many differences

between the OFHEO rules and the new recourse capital rules adopted by all of the U.S. bank regulators on November 29, 2001. These rules require dollar-for-dollar capital for unrated residuals, reflecting the significant risk of these instruments. However, OFHEO's rule does not provide for comparably stringent capital. Further, the proposed rules would give the GSEs massive RBC credit for risk transfers to unrated seller/servicers if these high-risk counterparties obtain a minimum amount of third-party credit risk protection. The bank regulators provide only limited and very conservative capital treatment for risk transfers, and we urge OFHEO to do the same.

2. Risk Cross-Subsidization Undermines the RBC Framework

OFHEO has taken no steps in this proposed rule to correct a fundamental flaw in the final rules: the fact that the GSE capital rules — in sharp contrast to all other capital standards for banks and insurers — permit cross-subsidization between credit and interest-rate risk hedges. As promulgated, the OFHEO rules would allow Fannie Mae or Freddie Mac to reduce its credit risk by putting on extra interest-rate risk hedges and transferring the capital credit achieved thereby to reduce credit risk-related capital charges. This is highly risky, in part because of the risks associated with derivatives and for reasons associated with credit and interest-rate risk. Thus, a GSE could well need its additional interest-rate risk coverage precisely at the same time its credit position is under pressure, leaving the institution sharply and suddenly under-capitalized.

3. GSE Debt Premium Should Reflect Real Risk

OFHEO has moved back and forth on the issue of imposing a premium on new GSE debt for the last nine years of the stress test. OFHEO's NPR2 suggested that a 50 bps premium would be appropriate, reflecting the fact that GSE debt spreads to Treasury rates have widened in times of financial stress. In the final rule, OFHEO postponed imposition of any new debt premium pending later refinements to the Rule. Now, OFHEO proposes to implement a 10 bps debt premium. OFHEO cites as its reason that "some funding strategies employed by the Enterprises depend significantly on relatively favorable interest rates." OFHEO also notes that, while firms in very stressful circumstances frequently face premiums of several hundred basis points — if they are able to borrow at all, the GSEs "have always been able to borrow, even when they are in very poor financial condition, because of their perceived special status." For this reason, OFHEO uses a much smaller debt premium than would be appropriate for a non-GSE in a similar stress test.

FM Watch believes OFHEO's reasoning in arriving at a minimal premium for new GSE debt reflects a fundamental flaw behind OFHEO's approach to the RBC rule. Instead of developing a rule to minimize the risk to the taxpayer from a GSE collapse during a stress period, the agency has chosen to assume the GSEs' preferred status will continue to shield them from market forces. This approach minimizes the risk-based capital cost to the GSEs of adding unnecessary interest rate risk to their portfolios through the repurchase of their MBS and other mortgage assets. Since these acquisitions increase shareholder profit while maximizing taxpayer risk, it would be more appropriate for OFHEO to impose a higher new debt premium on the GSEs.

4. RBC Capital Should be Adjusted to Reflect Derivatives Valuation

FM Watch urges OFHEO to act on one important issue not addressed in either the current or proposed RBC rule. OFHEO in these regulations has chosen to take a very different position on derivatives than the bank regulators, allowing the GSEs not only to reduce credit and interest-rate risk when these instruments are purchased, but also to subsidize risks with derivatives acquired for other purposes. Bank regulators, in contrast, take a very conservative view of derivatives, reflecting the fact that even interest-rate risk swaps — by far the most widely-accepted hedge — have yet to be fully tested during an economic downturn or under broad market stress conditions. We have noted our concerns related to cross-subsidization above.

OFHEO has compounded its excessively liberal treatment of derivatives by filing in its capital rules to adjust its definition of capital to reflect changes in derivative valuation. FM Watch would draw OFHEO's attention to the significant write-down in shareholder equity reported by Fannie Mae during the first three quarters of 2001. During this period, Fannie Mae took a FAS-133 required adjustment of \$10.6 billion in shareholder equity, reducing its shareholder equity by about one-third during this short period. Because OFHEO's capital standards do not adjust for these changes in derivatives valuation, a GSE could fully meet its regulatory capital standards even as its GAAP-measured shareholder equity fell dramatically.

The nation's S&L crisis during the 1980s taught a sharp and costly lesson about the importance of conforming regulatory accounting to GAAP. Indeed, Congress ordered the bank regulators to do so to the greatest degree possible in 1989. OFHEO should be guided by the same principle, especially given the systemic risk posed by each of its regulated parties and the federal government's implicit guarantee of them. Regulatory capital should be adjusted to reflect FAS-133 valuation in derivatives positions to ensure that the GSEs are well enough capitalized to meet the market risks related to their massive hedging operations.

5. Multifamily Credit Risk

These proposed rules would significantly relax the capital associated with multifamily related credit risk. FM Watch urges OFHEO to adopt tough credit RBC standards with regard to multifamily housing, which is historically the riskiest segment of the residential housing industry. The GSEs may argue that their multifamily commitments promote affordable housing, but FM Watch would note in response that the lax nature of the HUD affordable-housing standards do not in fact require GSE-backed multifamily projects to support low- and moderate-income individuals. The GSEs can and do invest in high-income related projects, such as recent investments by Freddie Mac in high-income cooperative apartments in New York City.

The revised capital standards for multifamily projects as proposed by OFHEO may create a strong incentive for the GSEs to expand into high-risk, high-income multifamily projects, since they will operate in this market at a strong capital advantage to all other lenders and securitizers. This does not promote the GSEs' mission of supporting affordable housing, and it will also significantly increase the GSEs overall risk to taxpayers.

Conclusion

FM Watch stands ready to provide OFHEO with additional detail on each of these concerns. We urge in the strongest possible terms that OFHEO move forward with changes that make the final RBC rules comparable to those that govern banks taking risks comparable to those at the GSEs.

Sincerely,

Mike House
Executive Director
FM Watch