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October 28, 2002

Mr. Alfred M. Pollard  
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*RegComments@OFHEO.gov*

Dear Mr. Pollard:

With this letter, FM Watch is pleased to expand upon the comments provided to OFHEO in response to its initial request for views on proposed revisions to the risk-based capital rules governing Fannie Mae and Freddie Mac (collectively the enterprises or GSEs). We appreciate OFHEO's decision, as requested, to expand the comment period on those aspects of the proposal that OFHEO itself has now conceded address a "critical element" – that is, the changed treatment of FAS-133 for purposes of assessing starting capital at the beginning of the stress test. However, in light of this new recognition of the impact of the proposal, OFHEO would have done better to withdraw it and consider more carefully the overall implications not only of this specific change, but also of the underlying risk-based capital standards and their ability to protect taxpayers and the global capital markets.

In this letter, FM Watch also reiterates concerns about the importance of ensuring that the capital standards governing the GSEs are no less stringent than those applied to banks and those dictated by complete recognition of GAAP throughout the capital standards. Our concerns here are heightened by disclosures in Fannie Mae's third-quarter, 2002 earnings with regard to a massive and sudden shift of \$135 billion from the GSE's "held-to-maturity" portfolio to that deemed "available for sale." Fannie's own release states that this shift was done to reflect the new risk-based capital rules. However, it is a transfer that increases the "available-for-sale" portfolio by 500%, suggesting that Fannie has undertaken a massive bookkeeping exercise to ensure nominal compliance with the rules without actually addressing its real risk. Bank regulators would, we believe, have blocked such a transaction, regardless of its nominal purpose, to ensure real compliance with risk-based capital standards, not just technical conformity with them. OFHEO presumably had appropriate knowledge of this transaction, which has major safety-and-soundness implications. Allowing it to proceed confirms our concern that the rules themselves are profoundly flawed.

FM Watch is a coalition of financial industry trade associations focused on ensuring that the GSEs operate within their charters and in a prudent fashion. Members of these associations must comply with strict capital standards imposed by both regulators and the market, and they are thus particularly concerned that those governing the GSEs are at least as stringent as those that govern banks. As you are aware, this "no-less-stringent"



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standard was adopted by Congress for savings associations in the wake of the savings and loan debacle, and we believe it is also a governing principle for the GSEs, especially in light of their systemic-risk potential.

In general, FM Watch believes that:

- OFHEO should withdraw this proposal until a definitive quantitative assessment of its impact can be made under numerous economic circumstances. As previously noted, the agency's own estimate of the proposal's impact varied considerably in the two days between a posting of the draft rule and its transmittal to the Federal Register. OFHEO should make no changes to the risk-based capital (RBC) rules without a full understanding of their impact and a transparent release of the assumptions on which this understanding is based, so that interested persons may validate these assumptions and provide OFHEO with useful analysis of them.
- The proposal violates key provisions in the Administrative Procedures Act, based on the fact that OFHEO could still implement it immediately, without the delay mandated by the APA or the still more advisable one adopted by bank regulators when they change RBC requirements.
- Due to the information standards guidelines required as of October 1, the proposed rule may now also violate the requirements of the Office of Management and Budget's Final Guidelines (67 FR 8452) that require that regulators meet various standards regarding the information on which they base their actions. Due to the significant variation in the data noted above, this proposal is in violation of OFHEO's own guidelines regarding, "objectivity, utility, and integrity." They are thus subject to potential judicial challenge, raising serious concerns about the ability of the GSEs to rely on their RBC rules for long enough to meet their charter requirement of stabilizing the nation's mortgage market.
- The proposal also continues to violate Executive Order 93-12866, based on the fact that the rule would have significant economic consequences. We are pleased to note that the Office of Management and Budget has agreed with our assessment and informed OFHEO in a letter dated October 17, 2002 that the final rule will be subject to formal review under EO 93-12866.

I. OFHEO Should Withdraw and Start Again, Not Just Extend the Comment Period

The proposal on which this comment is made continues to state that the proposal is "technical." However, in a September 20 letter to House Capital Markets Chairman Baker, Director Falcon has in fact stated that the amendment addresses a "critical element" of the RBC rule. This is consistent with FM Watch's understanding of the

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proposal based on the limited amount of information provided in the initial proposal. However, without additional background as to the implications OFHEO now anticipates should the rule be adopted, we are unable to provide informed comments on the proposal, and believe that others in the public are similarly hampered. As a result, comments on this proposal cannot effectively guide OFHEO in its final decision-making on the proposal. It should be withdrawn and, if appropriate, reissued in a complete form that permits a full and informed assessment as to those factors that make it a “critical element” and what so critical a rule will actually do in both the housing and financial markets.

Further, in his letter, Mr. Falcon commits to providing Chairman Baker with data on the impact of this proposed change during the third quarter of 2002, information essential to determining whether the rule would unduly benefit one or another of the GSEs under the heightened interest-rate risk environment of that period. As noted in our initial comment, FM Watch is particularly concerned that the proposal was intended as a stop-gap concession to Fannie Mae, based on levels of interest-rate risk throughout the third quarter well in excess of its management-determined boundaries (which could still represent an undue amount of risk). As noted, Fannie’s third-quarter earnings release compounds the perception that the proposal could have major implications for a GSE and for markets more generally. Fannie Mae’s massive portfolio shift may have been made when it became clear that OFHEO could not act as quickly as intended on the capital fix. Any proposal with so profound an impact on a GSE requires careful consideration with a full understanding of its impact under various economic and portfolio circumstances.

We would further note that OFHEO on September 30 released data on performance of the GSEs during the second quarter under the under-lying RBC rule, but failed to provide at that time or in the extension of the comment deadline information on how this proposal would have affected the GSEs using this more recent data. With only information on performance under the first quarter – and highly variable information at that – public comment on the proposal lacks essential data on which to advise the agency. OFHEO should thus provide complete and current data to the public on the proposed regulation, deferring action only until it can act with the benefit of this thorough assessment.

## II. Proposal Violates Administrative Procedures Act

Because OFHEO has simply reissued its proposal, not substantively revised it, the proposal on which we comment violates the Administrative Procedures Act (5 U.S.C. § 553(d)). Both Fannie Mae and Freddie Mac commented on this concern in their letters to OFHEO on the initial proposal, and FM Watch hereby notes our conclusion in support of these concerns. Without a statement as to when the final rule will be effective and a clear justification of any effective date sooner than thirty days after publication of the final rule, action on this proposal violates the APA. FM Watch also endorses Freddie Mac’s suggestion that OFHEO model implementation of changes to its capital rules on those of the bank regulators, which generally delay action on capital rule changes until the first

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day of the next full quarter following thirty days after publication of a final rule in the Federal Register.

Implementation of a final rule – should further detailed analysis support action on it – under the schedule adopted by bank regulators ensures introduction of the proposed changes without undue market disruption. Both Fannie Mae and Freddie Mac are critical to the smooth functioning of the secondary mortgage market, and sudden lurches in their risk-based capital requirements could well have undue impact on this market, based on the fact that capital requirements drive the amount of assets each GSE may hold.

### III. Proposal Violates OFHEO Information Quality Standards

The proposal also raises serious concerns due to new rules governing the quality of information on which agency actions must now be based. Pursuant to OMB Final Guidelines (67 FR 8452), OFHEO has issued its *Final Guidelines for Ensuring Quality of Disseminated Information and Procedures for Correction by the Public*, which governs the quality, objectivity, utility and integrity of the information on which its actions must be based after October 1. Failure to meet these standards could lead to challenge of the capital rule, forcing its revocation at a subsequent date and the exacerbation of market uncertainty because of the fundamental importance of GSE capital requirements to the smooth function of the secondary mortgage market.

FM Watch would note several aspects of the proposal which violate these guidelines. First, as noted, OFHEO substantially changed its estimate of the impact of the proposed revisions in the two days between posting the proposal on its website and sending it to the Federal Register for publication. Freddie Mac's capital surplus over these two days went from \$2 billion to the \$1.652 billion noted above; Fannie Mae's capital went from an increase in its capital surplus of \$300 million to a drop of \$121 million. Clearly, any rule based on such variable information – as well as information well out of date, as discussed in more detail above – fails any reasonable test for information quality.

OMB rules also require that the information on which agency action is based must be “capable of being substantially reproduced.” OMB goes on to state that the information standards “objectivity” criterion is only satisfied if conclusions can be reproduced through accepted methods, and simple release of an overall model may not be sufficient for actions based on such information to satisfy the requirements. Without considerably more information validated through detailed release of the underlying assumptions, FM Watch cannot attempt even to reproduce OFHEO's conclusions, let alone assess their objectivity. Thus, we believe the proposal violates the OMB requirements on this count as well.

### IV. Proposal Violates Executive Order 93-12866

Finally, in our initial comment, FM Watch stated that the proposal violates Executive Order 93-12866, which requires prior OMB review of regulatory actions with “significant” economic impact – with “significant” defined as actions with cost impact of

\$100 million or more. Since the receipt of our original comments, OMB has notified OFHEO that the proposal will be subject to formal review under EO 93-12866 and that such review will take into consideration the economic impact of the regulation. We applaud this finding and believe that OFHEO itself provides data that confirms the proposal is far from technical. Under its final calculation, the proposed change would reduce Freddie Mac's surplus under the capital rule by \$1.652 billion, based on first-quarter 2002 data. This is well above the \$100 million criterion for "significant" economic impact in the Order and – should the impact increase, as OFHEO says it well might – the impact grows still greater. Significant volumes of mortgage or MBS purchases could well ensue at a GSE as a result of this proposal, and these could in turn have profound impact on the overall mortgage market. Indeed, we calculate that the \$1.652 billion capital change for Freddie Mac drives \$66 billion in on-balance sheet portfolio growth and \$367 billion in off-balance sheet assets – impact estimates based on the 2.5% and 0.45% capital ratios for on- and off-balance sheet GSE assets required under law. Even if one might somehow deem a \$1.652 billion rule change as "technical" and outside Executive Order 93-12866, the impact of this change clearly belies any such interpretation.

## V. Fundamental Concerns

FM Watch has long argued that the risk-based capital rules that govern the GSEs must be no less stringent than those that govern insured depositories, and we remain opposed to the overall OFHEO capital rule because it fails this critical test. The results of the test run of the rule released by House Capital Markets Subcommittee Chairman Baker on July 23 indicate that, under one interest-rate scenario, one of the GSEs would have had a risk-based capital requirement under the OFHEO rule with a leverage ratio of 894:1 for on- and off-balance sheet assets. This is a truly astonishing result given their concentration risk in a single asset. Our review of the second-quarter data indicates that this first-quarter data was not an anomaly; the leverage ratios remain as high as 800:1 under the more recent capital figures.

FM Watch also believes that the OFHEO rule must either be consistent with generally-accepted accounting principles (GAAP) or be more stringent than them. This means applying FAS-133 and FAS-115 throughout the stress test, instead of using OFHEO's own best guess as to appropriate accounting in this critical aspect of the capital rules. Congress has mandated a comparable requirement for bank regulators in 12 U.S.C. § 1831n(a)(2). It similarly did so for the Federal Housing Finance Board for the Home Loan Bank capital standards in 12 U.S.C. § 1426(a)(5). OFHEO is required pursuant to 12 U.S.C. § 4502(4) to ensure that its definitions of the components of core capital meet GAAP, and we must therefore conclude that the lack of clarity over whether GAAP must also apply to the RBC rules results from OFHEO's failure to follow its clear statutory mandate, not from any decision by Congress to allow OFHEO – in sharp contrast to the bank regulators and the FHFBB – to pick and choose among those sections of GAAP that may meet its or a GSE's needs at any one point in time. The vital role the GSEs play in both the mortgage market and the overall economy requires that OFHEO use caution when calculating their RBC or when prescribing accounting standards to be used in its

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determination. In comments made August 4, 2002, Federal Reserve Bank of St. Louis President William Poole noted the critical importance of GSE capital and its disturbing variance from bank capital. FM Watch questions why OFHEO proposes to further widen the differences between its approach to RBC and that of the Federal Reserve Board.

Finally, we are confused by the proposal to apply the adjustment to GSE capital after all of the other factors necessary to determine the rule have been calculated. Indeed, we would note that the proposal adds a new ninth line to the RBC calculation after the hundreds of pages used to reach the other eight lines in the final calculation. One would have assumed that a "technical" change would not be so fundamental a revision to the final equation used to calculate capital compliance. However, we also note that the proposal requires the GSEs to add the 30% operational/management risk add-on only to the first eight lines in the capital calculation, not to the adjustment made in the new ninth one. We question this, since we read the 1992 Act as requiring the 30% add-on to the final determination of credit and interest-rate risk-based capital, and we do not believe Congress gave OFHEO authority to adjust the capital requirement any further thereafter. [12 U.S.C. § 4611(c)(2)]

#### Conclusion

Should OFHEO advance the proposal to final rule without addressing each of the issues noted above, FM Watch believes that it will further exacerbate the flaws in the current GSE risk-based capital rule. These are already so serious that Congress' intent in promulgating the risk-based capital standards in 1992 has been materially undermined. We urge OFHEO not only to defer action on this proposal, but also to review the larger one to correct these flaws and ensure that Fannie Mae and Freddie Mac operate under risk-based capital standards no less stringent than those governing banks holding comparable risk.

Sincerely,



Mike House  
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cc.

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