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Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Fourth Floor
Washington, DC 20052

Re: Fannie Mae's Comments on OFHEO's Proposed Prompt Supervisory Response and Corrective Action Rule, 12 CFR Part 1777

Dear Mr. Pollard:

Fannie Mae respectfully submits these comments in response to the Office of Federal Housing Enterprise Oversight's (OFHEO) Notice of Proposed Rulemaking setting forth its procedures for the administration of certain prompt corrective action (PCA) provisions in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992[1] (1992 Act), and its proposed establishment of a system of prompt supervisory responses to be taken upon the occurrence of certain non-capital related developments.

Executive Summary

Fannie Mae supports OFHEO's objective of developing a highly effective regulatory regime while avoiding undue regulatory burden. Fannie Mae and Freddie Mac play a critical role in providing access to stable and affordable housing finance, and it is imperative for the companies to remain at the forefront of global safety and soundness practices. We are concerned, however, that the proposed regulation does not foster a cutting edge approach to safety and soundness, but instead seeks to establish a rigid and mechanistic approach that is unnecessary for a regulator that supervises only two institutions, each engaged in the same mono-line business. In this regard, we have two overarching concerns about the regulation that we would like to highlight.

First, Subpart A of the proposal creates a wholly unnecessary bureaucratic process that is burdensome to Fannie Mae and OFHEO and that, among other things, could negatively impact the capital and housing finance markets. Notably, the list of proposed "developments prompting supervisory response" (DPSRs) represents a wide range of events with a wide range of potential

[1] Pub. L. 102-550, 12 U.S.C.A. §4501 *et seq.*

meaning and impact to Fannie Mae that lack any apparent relation to one another and have no apparent calibration of severity. Some of the proposed DPSRs are set exceedingly close to Fannie Mae's normal and customary operations and risk inappropriately inserting OFHEO into the day-to-day operations of Fannie Mae. Others describe or imply catastrophic events that would imperil the existence of the secondary market. The lack of calibration demonstrates that the proposed mechanical triggers are arbitrary.

Fannie Mae also believes that many of the DPSRs in Subpart A demonstrate a clear misunderstanding of how Fannie Mae conducts its business and are simply not relevant to its business. Fannie Mae strongly urges OFHEO to withdraw Subpart A of the proposed rule. If OFHEO decides to retain the prompt supervisory response regime of Subpart A, however, Fannie Mae strongly suggests that OFHEO's staff responsible for understanding Fannie Mae's business meet with Fannie Mae business personnel so that DPSRs meaningful to how Fannie Mae's business operates may be devised.

Second, Fannie Mae has serious concerns with various parts of the proposed regulatory text that purport to provide OFHEO with greater rights than Congress specified or intended under the plain language of the 1992 Act. OFHEO cannot create authority for itself through this proposed regulation without an appropriate statutory basis. In the same vein, the proposal paraphrases the applicable statutory provisions of the 1992 Act in a number of ways that create needless ambiguities and cause unnecessary confusion. Accordingly, Fannie Mae recommends that several provisions in the preservation of authority and definitions sections and in Subpart B be revised substantially or completely removed from the proposed rule prior to finalization.

Section-by-Section Comments

The following are Fannie Mae's comments on various sections of the proposal's preamble and regulatory text:

Prompt Supervisory Response

Subpart A of the proposal seeks to impose a framework of early intervention supervisory measures prompted by the occurrence of one or more of ten internal or external, non-capital events that may impact the companies. This process, as contemplated, is unnecessary, burdensome, and awkward. Although OFHEO's apparent goal is to create a broad, early intervention regime, Subpart A is not the way to accomplish that goal. Fannie Mae believes that adopting the proposed DPSRs as mechanical "tripwires" in Subpart A creates a serious risk of disrupting the activities of the companies in a manner that is completely unnecessary in order to achieve the goal of effective, non-burdensome oversight that is shared by OFHEO and the companies. Accordingly, Fannie Mae recommends that OFHEO withdraw Subpart A.

As discussed in detail below, many of the proposed DPSRs identified in the proposal are inappropriate triggers for regulatory action. For example, some of the DPSRs, as proposed, may be triggered during normal operating conditions and may result not only in unwarranted supervisory actions but also in unwarranted intrusion into the day-to-day business of Fannie Mae, and unwarranted adverse reactions by the investment community and the capital and housing markets. Potentially even more troublesome is the fact that a regulation engineered to generate a significant number of false alarms will benefit neither the regulator nor those members of the public -- investors, homebuyers and others -- who are directly or indirectly dependent upon accurate information regarding the condition of the enterprises. Any alarm mechanism that tends to "cry wolf" ultimately will defeat its own purpose.

Fannie Mae believes there are several reasons that militate against issuance of Subpart A of the proposal.

First and most importantly, the envisioned process would serve as a potential restriction on OFHEO's ability to respond swiftly, flexibly, and appropriately to supervisory problems that may arise. Fact-specific responses are required for supervisory issues. Seeking to establish detailed codification of a process that requires OFHEO to act in a specific manner if a DPSR occurs fails to reflect the reality that supervisory situations are fluid and demand a flexible response from the regulator. In several instances, the proposed rule creates very narrow responses to a DPSR that have to be implemented over an overly narrow period of time. Thus, prompt supervisory response would likely deprive the supervisor, the government's top and most knowledgeable professional in terms of the institution in question, of the flexibility to take what he or she believes are appropriate steps just when that level of judgment is most needed. It also puts the institution's condition and the supervisory response under a public microscope just when a measure of calm and confidentiality might assist the supervisor to work out a speedy solution.

Second, the proposed regulatory tripwire approach represents a significant extension of the PCA regimes that apply to insured depository institutions and the companies, respectively. The PCA provisions adopted for banks in the Federal Deposit Insurance Corporation Improvement Act of 1991[2] (FDICIA) were a significant departure from the pre-existing regulatory regime. They reflected a congressional vote of "no confidence" in the banking regulators, blamed for the lack of decisiveness and expedition in their handling of the thrift debacle in the 1980s and the banking crisis of the late 1980s and early 1990s. Congress' response was to significantly curtail the regulators' discretion, mandating various actions based on the capital level of the regulated institutions.

[2] Pub.L. 102-242, §131, adding new §38 to the Federal Deposit Insurance Act, 12 U.S.C.A. §1831o.

This curtailment of the regulators' discretion in dealing with troubled institutions was entirely understandable in view of the great losses that had recently been suffered by the banking industry and the federal deposit insurance funds. It is widely agreed that PCA and other provisions to toughen financial institution regulation in FDICIA represented a high water mark in the relatively intrusive, detailed, and non-discretionary approach to regulation of depository institutions.

It is noteworthy that the Congress soon reconsidered this approach. In 1994, it amended section 39 of the Federal Deposit Insurance Act,[3] which had required the federal banking agencies to promulgate safety and soundness standards by *regulation*, to permit the banking regulators to act by regulation *or* guideline.[4] After a rulemaking procedure involving extensive public comment, the banking agencies collectively determined that general safety and soundness guidelines were preferable to regulations.[5]

In light of this history, it seems anomalous that OFHEO, with no explicit statutory mandate to establish safety and soundness standards, by regulation or by guideline, should choose to limit its own discretion by establishing a mechanical tripwire regime, when the banking regulators, operating under a much clearer statutory requirement to act in this area, collectively determined that flexible guidelines were preferable. In fact, the section 39 guidelines adopted by the federal banking agencies are procedural in nature and not nearly so detailed as to include tripwires. Rather, the guidelines make suggestions to management concerning the types of policies and compliance and risk management programs that insured depositories should consider implementing. In this respect, Fannie Mae is unaware of any regulatory scheme comparable to the mechanistic tripwires OFHEO proposes here. Moreover, given that OFHEO adopted safety and soundness guidance last December that is comparable in many respects to the section 39 guidance adopted by the federal banking agencies, Fannie Mae simply fails to understand why the procedure proposed at Subpart A is necessary.

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[3] Pub.L. 103-325, §318, amending §39 of the Federal Deposit Insurance Act, 12 U.S.C.A. §1831p-1.

[4] Pub.L. 103-325, §318(b)(1). The Conference Report explains:

> This section amends section 39 of the Federal Deposit Insurance Act to give the banking agencies greater flexibility in implementing standards relating to asset quality, earnings, and stock valuation. Under current law, these standards must be implemented by regulation. When an agency determines that an institution has violated a standard, the agency must require the institution to submit a plan indicating how the institution will correct the deficiency. Section 318 permits the banking agencies to implement these standards by either regulation or guideline. When an agency implements these standards by guideline, the agency can decide whether or not to compel institutions that fail to meet the guideline to submit compliance plans. The agency does not have this discretion when it acts by regulation. House Conference Report No. 103-652 174-75, *reprinted in* 1994 U.S. Code Congressional and Administrative News, p. 2004-2005.

[5] *See* 60 Fed. Reg. 35674 (July 10, 1995).

Third, OFHEO's proposed tripwire approach in Subpart A is all the more puzzling because of differences between the banking industry and the companies relevant to the design of the respective supervisory regimes that should apply to each of them. There are still many thousands of insured depository institutions with diverse geographic and product orientations. Given this circumstance, it might be thought necessary to rely more on regulations of general application than on guidelines, with a regrettable but justifiable loss of flexibility. In contrast, there are only two companies regulated by OFHEO, each with operations tightly focused on the secondary residential mortgage market, and each with OFHEO examiners in residence. In such circumstances, efficiency and consistency of treatment do not require the imposition of regulations on matters that can be addressed better through the continuous exchange of information that takes place between OFHEO and the companies.

Fourth, OFHEO currently conducts a comprehensive, continuous, on-site examination of Fannie Mae, and, as the proposal suggests, OFHEO would likely be aware of any DPSRs that might be problematic for the company.[6] OFHEO already has the supervisory tools to work with the companies to assist in the correction of or response to such DPSRs and does not need to institute a formalized, regulatory process to do so. For this and other reasons, Fannie Mae believes that the supervisory response process set forth in Subpart A is unlikely to reflect the actual process that OFHEO would undertake in the event that it determined that a supervisory response might be necessary. This is further evidence of why this proposal is unnecessary.

Fifth, PCA is an extraordinary remedy. It is the ultimate weapon to be used to try to salvage a bad situation. Fannie Mae's concern is that the proposed rule advocates the use of this ultimate weapon, in the guise of a prompt supervisory response, when there may be fairly minor environmental changes, several outside of the companies' control but fully within their capacities to manage. Indeed, many of the DPSRs are not proven in terms of their relationship with any serious economic problems for the companies. The imposition of PCA, in the form of a prompt supervisory response, is unwarranted particularly when a specifically tailored supervisory approach will resolve the issue.

Sixth, there is a reason that the FDICIA PCA regime uses capital triggers and not more amorphous triggers, such as those outlined in the proposed rule. Capital triggers are believed to be reasonably clear in terms of when they occur, and they are at the heart of what is clearly a safety

[6] To the extent proposing to codify these DPSRs in regulation reflects OFHEO's concern that it would not be aware of such triggering events, we suggest such concern is misplaced, given the size and professionalism of the agency's examination staff.

and soundness metric.[7] The proposed DPSRs are amorphous and may not actually be linked to any problems of the institution. By causing management and examiners to take steps in situations where there may be no problem at all, this proposed rule takes away both management and examiner time that should be used to address real business and supervisory issues, respectively.

Seventh, there is nothing in the proposed regulation that indicates that the process, communications, or documentation involved in a Subpart A supervisory response would be confidential. OFHEO's attempt to make its regulation "more transparent" to the public through the addition of Subpart A could result in unwarranted and inappropriate disclosure of supervisory actions, discussions, or correspondence that could be misunderstood by the public and abusively exploited by competitors.[8] This could cause the public and the capital and housing finance markets to lose confidence not only in the affected company but quite possibly in the entire housing agency market. Moreover, bad press has a way of becoming a self-fulfilling prophecy by raising funding costs that could lead to capital problems. The potentially public nature of the proposed approach is akin to crying "fire" in a crowded theater -- it is likely to cause excessive public alarm that will make markets less rational arbiters of the company's condition thereby narrowing the potential responses of both the company and OFHEO. Such a situation would in no way advance the regulatory objective.

If OFHEO is unwilling to remove completely the mechanical tripwires outlined in Subpart A of the proposal, as Fannie Mae suggests it should, OFHEO should consider that the tripwires would be more appropriately framed as internal guidance than formal regulation. In this way, the process could be used as an OFHEO "fail-safe" or internal threshold for evaluating potentially troublesome situations and formulating an appropriate strategy for resolving them. OFHEO's supervisory team could create internal guidance that includes supervisory triggers. Such triggers could cause the examiner to ask additional questions, to perform additional examinations to determine whether a problem exists, and then to take appropriate supervisory steps to rectify a problem. But such triggers should be entirely internal to the supervision team for two reasons. First, the triggers are likely to change over time as OFHEO's knowledge regarding the most important safety and soundness causal events increases. Second, internal guidance allows the examiners to fashion a response that is suited to the particular circumstances. Even where the trigger may suggest a real safety and soundness problem, in today's financial services environment each such problem is going to have a different complexion, and the supervisory response to such problems is likely to be

[7] Indeed, when Congress was debating the merits of a PCA regime for insured depository institutions in 1991, Federal Reserve Chairman Alan Greenspan testified before Congress that "'capital is a leading indicator of the financial condition and future performance and solvency of a bank' and should be the basis for PCA." 137 Cong. Rec. H2907, 102nd Cong., 1st Sess., May 9, 1991.

[8] This is particularly true if, because of their status as public companies, a Level I supervisory letter causes an unintended disclosure obligation for Fannie Mae or Freddie Mac.

somewhat different. A "one-size fits all" response in the dynamic, global, financial world of the 21st century is inappropriate.

Moreover, if OFHEO pursues a prompt supervisory response regime either as part of this proposed regulation or internal guidance, Fannie Mae has significant concerns about some of the specific DPSRs proposed in Subpart A. As mentioned above, the list of proposed DPSRs represents a wide range of events with a wide range of potential meaning and impact to Fannie Mae. Some of the proposed DPSRs are set exceedingly close to Fannie Mae's normal and customary operations and risk, inappropriately inserting OFHEO into the day-to-day operations of Fannie Mae – something Congress admonished OFHEO from doing.[9] Others represent potential catastrophic events. Moreover, all of the DPSRs taken together lack any apparent relation and have no apparent calibration of severity, further indicating the arbitrariness of the proposed approach. Not only are the nine enumerated DPSRs difficult to calibrate, their calibrations would necessarily change over time.

Accordingly, Fannie Mae has the following specific comments with respect to each enumerated DPSR:

> ***1. OFHEO's national House Price Index (HPI) for the most recent quarter is more than two percent less than the national HPI four quarters previously, or for any Census Division or Divisions in which are located properties securing more than 25 percent of single-family mortgages owned or securing securities guaranteed by an enterprise, the HPI for the most recent quarter for such Division or Divisions is more than five percent less than the HPI for that Division or Divisions four quarters previously.***

Adopting this DPSR would provide misleading and confusing signals of risk, lead to unwarranted triggering of the prompt supervisory response process, and cause an inappropriate intrusion into Fannie Mae's day-to-day operations. Thus, Fannie Mae suggests that it be withdrawn.

While movements in home prices are important potential contributors to total credit risk for the company, changes in home prices alone do not offer a complete or accurate picture of the credit risk of Fannie Mae or its financial strength. Credit risk for Fannie Mae is a complex mixture of many things, including such critical items as the original loan-to-value ratio of loans acquired, changes in the loan-to-value ratios since acquisition by Fannie Mae, the demonstrated willingness and ability of the borrower to pay (irrespective of what may or may not happen to home prices), and

[9] *See* S.Rep. 102-282 (1992) at 25, which clearly indicates that OFHEO should not impose its business judgment on, or interfere with, the normal management prerogatives of a company that has sound financial controls, is adequately capitalized, and is profitable. *See also*, H.Rep. 102-206 (1991) at 52.

credit enhancements. These critical factors, often more important than spot changes in home prices, are ignored in the proposed trigger. Indeed, it is entirely possible for Fannie Mae's credit risk to go down even as home prices decline because these other factors offset the impact.

As of March 30, 2001, Fannie Mae's single-family credit portfolio had an original loan-to-value ratio of 74.9% and a mark-to-market loan-to-value ratio of 57.7%. It would require a decrease in home prices of more than 20% in the whole country, or 10 times the threshold proposed by OFHEO, to eliminate the equity built up over the years on Fannie Mae loans. Similarly, the proposed trigger ignores the beneficial impact of credit enhancements that as of March 30, 2001 provided protection on more than 37% of the loans in Fannie Mae's credit portfolio. During the year 2000, credit enhancements absorbed more than 80% of the gross losses incurred on Fannie Mae loans.

Ignoring factors as significant as the growth in home equity and credit enhancements raises significant questions about the appropriateness of this measure. To judge the health of the company based on an exogenous home price index totally misses fundamental aspects of the company's business.

Fannie Mae is even more concerned that the proposal goes a step beyond just looking at a nationwide index but adds a further test based on census divisions. Diversification is one of the keys to reducing risk, and one of the basic reasons that Fannie Mae is a low-risk company is the fact that the mortgages it funds or guarantees are from all across the country. Exhibits 1 through 3 show the risk-reducing benefits of national diversification as compared to what would pertain in a census division.

In Exhibit 1, the maximum quarterly foreclosure rate nationwide from 1970 through 2000 (0.26% in the fourth quarter of 1991) was lower than the maximum in any one of the census divisions.[10] Exhibits 2 and 3 show that the maximum foreclosure rates in the New England and the West South Central Census Divisions reached levels that were approximately double the maximum delinquency rate nationwide.

If we look at home prices, between third quarter 1990 and third quarter 1991, for example, the New England Region experienced home price declines that exceeded the proposed triggers. However, Fannie Mae's net income during the same time period increased 17%, while net charge-offs for single family loans in portfolio and backing MBS declined 24%.

Downturns in housing prices of the amount contemplated in the proposal are part of the normal course of business and do not threaten the financial solvency of Fannie Mae. We expect

[10] The foreclosure rates in Exhibits 2 through 4 are for 1-4 family residential properties and are taken from the National Delinquency Survey conducted by the Mortgage Bankers Association of America.

that regions of the country will periodically experience economic downturns that impact home prices by at least the amount inherent in the proposed triggers. And, we manage our credit risk position accordingly using credit enhancements, underwriting standards, and servicing standards.

Fannie Mae is in the business of risk transformation. To base a DPSR on changes in the HPI is to base a judgment of the company on a proxy for its raw materials. The judgment is based on a measure of the risk of the inputs before the company transforms those risks. Any judgment that needs to be made should be based instead on risk measurements that take the company's risk management into account. Indeed, it is hard to understand why OFHEO would do otherwise -- why it would make judgments based on a remote proxy when it has examiners on-site that have unparalleled access to far better data about the actual risk to which Fannie Mae is exposed.

For all of these reasons, Fannie Mae recommends that this DPSR be withdrawn. If, however, OFHEO retains this DPSR either in regulation or guidance, Fannie Mae believes that it should focus on situations in which the financial strength of Fannie Mae is at risk. Fannie Mae suggests an alternative approach that focuses on changes in estimated future credit losses. As part of its voluntary disclosure initiatives, Fannie Mae already discloses the impact of a 5% drop in home prices on its estimated future credit losses. As of December 31, 2000, the impact was appropriately small, reflecting the quality of our book of business and the impact of credit enhancements.[11] Fannie Mae closely monitors the contribution that changes in the HPI make to its overall credit risk through such metrics and suggests that OFHEO consider a DPSR based on this more comprehensive and accurate approach.

2. An enterprise's interest rate risk, as assessed by any internal measure, exceeds the limit at which the enterprise's policies and procedures require a report of such exception to its board of directors.

Fannie Mae considers this DPSR to be overly broad and an inappropriate intrusion upon the day-to-day management of its business and suggests that it be withdrawn. Fannie Mae engages in full and regular reporting to its board of directors on interest rate risk management, among other things. In fact, Fannie Mae's board of directors has assigned its Assets and Liabilities Policy Committee oversight responsibility for Fannie Mae's interest rate risk management. Pursuant to a board-adopted charter for that committee, Fannie Mae's Chief Financial Officer periodically reports to the committee on Fannie Mae's interest rate risk management activities. This reporting also occurs on a schedule developed by the chair of the Assets and Liabilities Policy Committee in consultation with management.

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[11] *See* Fannie Mae's Information Statement dated March 30, 2001 at 15;
http://www.fanniemae.com/markets/debt/pdf/infostatement033001.pdf (visited June 27, 2001).

Ironically and perversely, this vaguely worded and overly broad standard could provide Fannie Mae with a disincentive to continue this open and meaningful reporting to the committee and the board, so as to ensure that a prompt supervisory response for OFHEO is not triggered. We seriously question whether OFHEO intends to create such disincentive. Moreover, we note that the 1992 Act has imposed upon Fannie Mae and Freddie Mac a risk-based capital regime that takes into account significant variances in interest rate risk exposure and which Fannie Mae and Freddie Mac have managed effectively and efficiently to date.

3. An enterprise's net income for the most recent calendar quarter is less than one-half of its average quarterly net income for any four-quarter period during the prior eight quarters.

Unlike some of the other proposed DPSRs, a change of this magnitude in Fannie Mae's net income very likely would indicate a severe business problem. Nonetheless, Fannie Mae believes that using a fixed net income target to trigger a prompt supervisory response is conceptually flawed and inappropriate. In some cases, supervisory response may be warranted before the proposed trigger is reached, while in other cases no supervisory response will be needed even if the proposed trigger is met. (An example of the latter circumstance might be a one-time change to net income mandated by a change in an accounting standard). Because this DPSR fails to add anything meaningful to the existing examination-based supervisory regime, it should be withdrawn.

4. An enterprise's net interest margin (NIM) for the most recent quarter is less than one-half of its average NIM for any four-quarter period during the prior eight quarters.

Similar to DPSR no. 3, Fannie Mae believes that a fixed net interest margin target with no business context is a poor trigger for prompt supervisory response. Again, supervisory response may be appropriate before the proposed trigger is met, or may not be needed if the proposed trigger is met. This DPSR adds nothing meaningful to the existing examination-based supervisory regime and should be withdrawn.

5. For single-family mortgage loans owned or securitized by an enterprise that are delinquent ninety days or more or in foreclosure, the proportion of such loans in the most recent quarter has increased more than one-half of a percentage point compared to the lowest proportion of such loans in any of the prior four quarters.

As would be the case with the use of HPI alone as an indicator of risk (*see* DPSR no. 1 above), delinquencies in isolation are an incomplete indicator of Fannie Mae's risk, and thus, this DPSR is conceptually flawed. This DPSR fails to add anything meaningful to the existing examination-based supervisory regime because OFHEO examiners already have access to

delinquency and foreclosure data, as well as data on home equity and credit enhancements. Because it will not further materially the achievement of OFHEO's regulatory objectives, Fannie Mae urges that this DPSR be withdrawn.

6. An enterprise's equity, as measured on its Consolidated Fair Value Balance Sheet as of the end of a calendar year, is ten percent less than the enterprise's equity so measured as of the end of the previous calendar year, and is ten percent or more below the amount of its core capital.

Fannie Mae considers this DPSR to be unwarranted and suggests that OFHEO withdraw it. The fair value of a company's equity can be quite volatile, for reasons that have little to do with the economic health of a going concern. Fair value seeks to determine a company's liquidation value, not its strength as an ongoing business.

Moreover, this proposed DPSR is set exceedingly close to Fannie Mae's normal and customary operations and risks inappropriately inserting OFHEO into the day-to-day operations of Fannie Mae. One situation in which this DPSR could be triggered easily despite normal business conditions and Fannie Mae's strong financial health would be a sharp bond market rally accompanied by greater spreads between mortgages and Fannie Mae's debt costs. Such conditions could cause the fair value of our equity to drop below the proposed trigger for prompt supervisory response, even as our business prospects were improving and our stock price in all likelihood was increasing.

Probably of greatest importance is that this DPSR, if promulgated, would cause us to change our hedging significantly, and in a way that would be clearly detrimental to our health as an ongoing concern. This would be an unwise and unwarranted intrusion upon the day-to-day operation of Fannie Mae's business. In this regard, we question what regulatory purpose is served by forcing Fannie Mae to change the way it manages its business, something OFHEO has consistently found to be sound -- and has told Congress and the public as much. To promulgate this DPSR would be to violate a regulator's first rule: "first, do no harm."[12]

7. An enterprise experiences material and sustained disruptions to its data processing or operational systems.

This DPSR is too vague. It is unclear to Fannie Mae what disruptions would constitute "material and sustained," and Fannie Mae is unsure whether it can be appropriately and accurately

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[12] *See* Remarks by Eugene A. Ludwig Comptroller of the Currency before the American Enterprise Institute, October 9, 1997, 1998 OCC QJ LEXIS 16; 17-1 O.C.C. Q.J. 101 (March, 1998); *see also* Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 13, 2000, 86 Federal Reserve Bulletin Number 6 at 405 (June, 2000).

defined or quantified so as to permit a reasonable basis for understanding. Moreover, it is unclear what "data processing" or "operational systems" mean.

Fannie Mae focuses intently upon backup and recovery facilities, systems, and processes that make it unlikely that an adverse event would negatively affect our business in any material way. Without an appropriate definition for this DPSR, OFHEO could inappropriately trigger a prompt supervisory response during normal operating conditions. In fact, action taken by OFHEO in response to some event may cause counterparties to react negatively toward Fannie Mae, resulting in an unintended adverse impact upon Fannie Mae's business. Accordingly, because this DPSR cannot be appropriately quantified, Fannie Mae suggests that OFHEO withdraw it.

8. An enterprise changes its external auditor without cause.

Fannie Mae has a number of concerns with this vague and arbitrary section of the proposed rule and suggests that it be withdrawn. It is unclear to Fannie Mae what OFHEO means by "cause." Corporations change their external auditor periodically because of changes in relationships, consolidation of auditing firms, and other reasons. Good management dictates that a company not be blindly wedded to any particular service provider and that it should periodically investigate relevant alternatives.

Fannie Mae is unaware of any regulatory scheme where automatic supervisory action is triggered as a result of a change in independent accountants. The Federal Deposit Insurance Act and the FDIC's implementing regulations only require insured depository institutions and their independent accountants to report (and explain, in the case of depository institutions) certain events -- including a change in or termination of accountants -- to the FDIC as well as the institutions' respective primary banking regulators.[13] Similarly, Securities and Exchange Commission (SEC) rules only require a public company to disclose publicly any change in auditor.[14] There is no immediate supervisory response to such change. If Fannie Mae were to change its auditor, it would report this fact in its quarterly information statement.

In fact, according to its listing agreement with the New York Stock Exchange (NYSE), Fannie Mae is required to notify the NYSE if it changes its auditor or recommends to shareholders that the auditor should be changed. Failure to do so would result in Fannie Mae being delisted from the NYSE. As OFHEO can surely appreciate, delisting would, at a minimum, cause a very significant negative reaction in the capital and housing finance markets, and it is an event that Fannie Mae would not let occur.

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[13] 12 U.S.C.A. §1831m(g)(5), (h)(2)(B); 12 C.F.R. §§363.3(c), 363.4(d).

[14] *See* Rules 13a-11 and 15d-11 under Sections 13 and 15(d) of the Securities and Exchange Act of 1934, respectively.

As Fannie Mae's NYSE listing agreement states, the corporation's "audit committee and Board of Directors have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement)." It is not a regulator's prerogative to second-guess decisions inherently placed with and made by a company's management. This non-quantitative, non-economic DPSR underscores the unnecessary nature of this prompt supervisory response regulatory regime and the fact that OFHEO would be best served by withdrawing Subpart A or, at a minimum, designating Subpart A as internal OFHEO guidance rather than issuing a formal regulation.

9. The board of directors of an enterprise fails to hold a scheduled meeting without cause.

As with the change in auditor DPSR above, Fannie Mae considers this DPSR vague and arbitrary. It is unclear to Fannie Mae what OFHEO means by "cause." For these and the reasons set forth below, Fannie Mae suggests that this DPSR be withdrawn.

Fannie Mae keeps its board of directors informed and regularly communicates with and meets with the board. The decision concerning how many meetings to have, whether to combine previously-scheduled meetings or cancel them, and when meetings will be held is within the purview of Fannie Mae's board of directors and its senior management. Under its listing agreement with the NYSE and its bylaws, Fannie Mae is required to hold only an annual meeting. Because of the size of the company, however, and because it chooses to do so in the exercise of sound management and good corporate governance, Fannie Mae holds board meetings more often than annually. The number of meetings, however, is not necessarily the same from year to year, and senior management in consultation with the board constantly reevaluates the need for particular meetings at particular times. The fact that Fannie Mae may fail to hold a "scheduled meeting" is not an appropriate cause for regulatory action. Again, as has always been the case, we invite OFHEO to ask questions of Fannie Mae in its role as supervisor and examiner if it does not understand why a particular action has been taken. Codification of this procedure in a regulation does not alter whatever authority OFHEO has in this regard.

10. Any other development, including conduct of an activity by an enterprise, that OFHEO determines in its discretion presents a risk to the safety and soundness of the enterprise or a possible violation of applicable law, regulation or order.

Fannie Mae considers this catch-all provision to be vague, arbitrary, and inappropriate and suggests that it be withdrawn. To allow OFHEO complete "discretion" to trigger the prompt supervisory response regime appears to contradict completely the need for the nine specific indicators previously discussed. In this, and many other respects, it underscores the fact that

Subpart A is completely unnecessary, would create more regulatory burden for Fannie Mae, and would generate unwarranted bureaucracy for OFHEO. Moreover, the fact that some alleged "possible violation" of law, irrespective of its source, could cause a prompt supervisory response seems to lack fundamental fairness and due process and underscores the rigidity of the proposed process. This DPSR could create an avenue for baseless attacks and allegations by detractors and competitors that become a regulatory burden for both OFHEO and the companies.

Accordingly, Fannie Mae believes that Subpart A would serve no material regulatory purpose, would result in additional, unnecessary burden to OFHEO and Fannie Mae, and would unduly confine OFHEO to a prescribed initial course of prompt supervisory action that would not be likely to be meaningful or appropriate given the circumstances. For all of the foregoing reasons, Fannie Mae suggests that OFHEO withdraw Subpart A from its proposed regulation. If OFHEO is unwilling to reject completely the process outlined in Subpart A of the proposal, OFHEO should consider that this process would be more appropriately framed as internal guidance than formal regulation. If OFHEO chooses this course of action, Fannie Mae suggests that it modify the proposed DPSRs as suggested above, and after further consultation with the two companies.

Preservation of Authority and Definitions

Fannie Mae has concerns with a number of provisions in the preservation of authority and definition sections of the proposed rule. Generally, and as expressed above, various parts of the proposed regulatory text provide OFHEO with greater authority than Congress specified in the plain language of the statute. OFHEO simply cannot create authority for itself through this proposed regulation without an appropriate statutory basis. In addition, Fannie Mae is concerned that other provisions of the proposal paraphrase the 1992 Act in ways that fail to clarify or provide appropriate interpretation to the affected section and contain technical errors that should be addressed.[15] Fannie Mae's comments on specific provisions in the preservation of authority and definitions sections are as follows:

Section 1777.2(b), Capital Floor. The proposal states that classification of an enterprise as "adequately capitalized" means that the enterprise meets the statutory requirements of Sections 1361 and 1362 of the 1992 Act,[16] but that nothing in "subpart B of this part or subtitle B of the 1992 Act limits OFHEO's authority to address circumstances that would require additional capital through regulations, orders, notices, guidance, or other actions." Fannie Mae disagrees with this assertion. The 1992 Act does not authorize OFHEO to require an increase in the company's capital

[15] We have identified many of the provisions with drafting concerns but it is likely that we have missed some. We urge OFHEO not to paraphrase the statute, but rather recite its text in the regulation verbatim unless it is interpreting statutory text that is ambiguous on its face and notes that fact in the proposal.

[16] 12 U.S.C.A. §§4611, 4612.

levels beyond what is prescribed by statute. The 1992 Act specifically sets forth the capital requirements for the enterprises, and makes the risk-based capital standard, in particular, more stringent than any capital requirements applicable to federally-insured banks or thrifts. Because these heightened standards apply to the enterprises, there is no authority for -- and certainly there is no need for -- "discretionary" supplements.

Moreover, excess capital does not serve a legitimate safety and soundness goal. Excess capital inhibits Fannie Mae's ability to accomplish its mission because it depresses Fannie Mae's return on equity and is likely to increase funding costs. Increased cost of operation and a less efficient company translate into a lessened ability to fulfill our congressionally mandated mission. Again, such result does not achieve the regulatory objective.

Section 1777.3, Capital Distribution. The proposal asks whether there are any additional types of payments that could be considered "capital distributions" and whether OFHEO should exercise its authority to include them in the regulatory definition. Fannie Mae believes that OFHEO has captured sufficiently the full range of actions that could constitute a capital distribution, and, thus, there is no need for any additions to be made to the regulatory definition.

Fannie Mae also notes that the regulatory definition of "capital distribution" includes an approval right for certain retirement plans that are "substantially equivalent to" section 401 plans and thus exempt from the definition of capital distribution. Fannie Mae disagrees with the assertion that OFHEO has such an approval right. Section 1303(2) of the 1992 Act merely provides that a "substantially equivalent plan, *as determined by the Director*, shall not be considered a capital distribution."[17] Thus, the Director's power is limited to ruling upon whether the plan is "substantially equivalent" to a section 401 plan. We suggest that the proposal be modified to track the statutory language of the 1992 Act as follows:

> *Capital Distribution* means ...
> (2) Any payment made by an enterprise to repurchase its shares for the purpose of fulfilling an obligation of the enterprise under an employee stock ownership plan that is qualified under section 401 of the Internal Revenue Code of 1986 or any substantially equivalent plan, as determined by the Director, shall not be considered a capital distribution.

Section 1777.3, Affiliate. It is unclear to Fannie Mae why this provision is necessary. The only place in the proposal where "affiliate" appears is within the definition of "enterprise." Moreover, the 1992 Act clearly sets forth the definition of affiliate, and the proposal's definition does not meaningfully amplify or interpret that statutory definition.

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[17] 12 U.S.C.A. §4502(2) (emphasis added).

Section 1777.3, Total Capital. The proposal provides that "Total capital has the same meaning as provided at 12 CFR 1750.11(n);" however, we cannot find such a provision nor can we find a definition for total capital anywhere in OFHEO's regulations. We suggest that OFHEO replace the proposed citation with the statutory reference, 12 U.S.C. §4502(18), as follows:

Total capital has the same meaning as provided at 12 U.S.C. §4502(18).

Prompt Corrective Action

Fannie Mae has concerns with several provisions of the codification of the PCA sections of the 1992 Act in Subpart B of the proposal. As expressed above, various parts of the proposed regulatory text purport to provide OFHEO with greater authority than Congress specified in the plain language of the statute. OFHEO simply cannot create authority for itself through this proposed regulation without an appropriate statutory basis. Moreover, various other provisions paraphrase the 1992 Act in ways that fail to clarify or provide appropriate interpretation to the affected section and contain technical errors that should be addressed. Fannie Mae's comments on specific sections are as follows:

Section 1777.20, Capital Classification and Reclassification. Fannie Mae has several issues with the proposed regulatory codification of the capital classification and discretionary reclassifications provisions of the 1992 Act.

First, Fannie Mae notes that the proposal recognizes the various implementation dates for various sections of the PCA provisions contained within the 1992 Act and separates the actions OFHEO may take into those occurring before one year after the effective date of the risk-based capital (RBC) rule and those occurring after that period. Fannie Mae objects, however, to the proposal's assertion in proposed Section 1777.20(c)(5) that OFHEO has authority to impose a discretionary reclassification upon a company that is classified as "adequately capitalized" during the period that is before one year after the effective date of the RBC rule. Section 1364(d) of the 1992 Act[18] clearly provides that "notwithstanding any other provision of this section," until one-year after the effective date of the RBC rule, OFHEO must classify an enterprise as "adequately capitalized" if it meets or exceeds its minimum capital requirement. This means that OFHEO does not have discretionary reclassification authority under Section 1364(b) of the 1992 Act[19] nor does it have reclassification authority under any other applicable law. Accordingly, OFHEO has no authority for and should remove the asserted reclassification authority from proposed Section 1777.20(c)(5) and all of its subparts.

[18] 12 U.S.C.A. §4614(d).

[19] 12 U.S.C.A. §4614(b).

Second, Fannie Mae also disagrees with the proposal's unsupportable modification in proposed Section 1777.20(a)(5)[20] to the grounds under which OFHEO has discretionary reclassification authority. Section 1364(b) of the 1992 Act provides OFHEO only two grounds for discretionary reclassification of an institution: (1) if an enterprise "is engaging in conduct not approved by the Director that could result in a rapid depletion of core capital;" or (2) "the value of the property subject to mortgages held or securitized by the enterprise has decreased significantly."[21] Proposed Section 1777.20(a)(5) of the proposal, however, would add a third trigger that would allow reclassification if it "is otherwise deemed necessary to ensure that the enterprise holds adequate capital and operates safely." It appears that this language may have been inappropriately imported from the provision in Section 1313 of the 1992 Act[22] establishing the Director's duties. The general language establishing the Director's duties does not modify the more specific and narrow language granting OFHEO certain specific discretionary reclassification authority that could form the basis for an enforcement action.

Moreover, proposed Section 1777.20(a)(5) omits certain statutory text that requires the conduct that results in a rapid depletion of core capital to have been conduct "not approved by the Director." OFHEO's omission of these five words radically changes the circumstances under which OFHEO can effectuate a discretionary modification. If OFHEO approved the conduct, the statute's plain language clearly states that it does not have the right to reclassify Fannie Mae's capital classification.[23] Fannie Mae suggests that proposed Section 1777.20(a)(5) be revised to track the statute as follows:

> (5) *Discretionary Reclassification.* – (i) *Determination to reclassify.* If at any time the Director determines in writing that an enterprise is engaging in conduct not approved by the Director that could result in a rapid depletion of core capital or that the value of the property subject to mortgages held or securitized by the enterprise has decreased significantly, the Director may classify the enterprise --

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[20] The proposal also contains the same objectionable text in proposed Section 1777.20(c)(5). Because OFHEO does not have statutory authority to promulgate proposed Section 1777.20(c)(5), Fannie Mae does not include that provision in this discussion. Fannie Mae asserts that all of its arguments applicable to proposed Section 1777.20(a)(5) are also applicable to proposed Section 1777.20(c)(5).

[21] 12 U.S.C.A. §4614(b).

[22] 12 U.S.C.A. §4513.

[23] The proposed rule also defines the statutory word "conduct" as "action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result" in the triggering event. Fannie Mae does not understand why this word needs to be defined and suggests that the definition provided is awkward and cumbersome, particularly when the statutory requirement that the conduct has to have been that which was "not approved by the Director" is added back to the text.

(A) as undercapitalized, if the enterprise is otherwise classified as adequately capitalized;

(B) as significantly undercapitalized, if the enterprise is otherwise classified as undercapitalized; and

(C) as critically undercapitalized, if the enterprise is otherwise classified as significantly undercapitalized.

Third, proposed Section 1770.20(b) provides that conduct resulting in a discretionary classification will be taken into account in each subsequent classification and that if such conduct continues without remedy "within such reasonable period as is determined by OFHEO to be appropriate," OFHEO may consider such failure to remedy to be the basis for a further reclassification. Fundamental fairness would dictate that OFHEO should provide advance notice to the affected company regarding what OFHEO considers a "reasonable period" of time for the conduct to be remedied. Fannie Mae suggests that the proposal be revised accordingly.

Fourth, proposed Section 1777.20(b)(1) gives OFHEO virtually unbridled discretion in determining whether discretionary capital reclassifications should be terminated. Fannie Mae believes that leaving such significant decisions to the unlimited discretion of the supervisory agency is unfair to the companies. As an alternative, Fannie Mae suggests that any adverse capital classification or reclassification should be presumptively terminated within 15 days after the affected company provides a certification by an executive officer that the conditions giving rise to the classification have been corrected for at least one calendar quarter and remain so as of the date of the certification. Any such findings should be appealable through an independent intra-agency process, as recommended below.

Section 1777.21, Notices of Classification. Fannie Mae has some general concerns with this proposed section as well as specific recommendations regarding certain proposed subsections.

Unlike the structure of the 1992 Act, which has one combined provision for notices of capital classifications and notices of supervisory actions in Section 1368 of the 1992 Act,[24] the proposed rule breaks these notices into two distinct notice sections. It is unclear why the proposed rule is drafted this way, which creates the opportunity for ambiguities to arise when the language of the statute itself is plain and clear.[25] Fannie Mae also notes that OFHEO's pending risk-based

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[24] 12 U.S.C.A. §4618.

[25] Fannie Mae notes that the statute clearly accomplishes this task in approximately five paragraphs while the proposed rule's two provisions combined include more than twice that number.

capital regulation[26] includes a detailed classification and notice procedure, and it is not clear which provision would be operative if both regulations were finalized. Fannie Mae suggests that tracking the statute in this rulemaking would simplify the applicable procedural steps, avoid any apparent ambiguities because the statutory text is clear, and make clear which regulatory procedure is the operative one.

In proposed Section 1777.21(a)(1)(ii), the proposal incorrectly asserts that OFHEO is not required to provide any subsequent notice of further capital reclassification. Sections 1368(a) and (b) of the 1992 Act require that any discretionary reclassification and any discretionary supervisory actions applicable to undercapitalized and significantly undercapitalized companies (except for appointment of a conservator) must be preceded by written notice of the proposed action, the proposed reasons for that action and the information upon which it is based.[27] OFHEO's ability to combine notices under this provision does not vitiate its obligation to provide additional notice when it takes new action. Accordingly, OFHEO must provide such notice in advance of the action, and the proposed rule should be revised to comply with the statute.[28]

In proposed Section 1777.21(a)(2)(i), the proposed regulation does not follow the statute, and Fannie Mae suggests it be revised to do so. The proposal reserves the right for OFHEO to accelerate the time period for a company to respond to a capital classification if OFHEO "determines a shorter period to be appropriate." Section 1368(c)(3) of the 1992 Act permits acceleration of the response period only if the "Director determines that the condition of the enterprise so requires."[29] Appropriateness as determined by the Director is a vague and unduly broad standard that does not comply with the statute. Congress explicitly intended that OFHEO give the company the full statutory period to respond to a classification unless "the condition of the enterprise" requires shortening the period. Thus, the only grounds upon which such acceleration can occur are grounds focused upon a company's condition, and the Director's decision must be based upon that – not upon whether the Director thinks action is "appropriate."[30] In fact, the capital classification notice provision of OFHEO's proposed risk-based capital rule appears to recognize this distinction because it tracks the statute.

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[26] 64 Fed. Reg. 18084 (April 13, 1999).

[27] 12 U.S.C.A. §§4618(a) and (b).

[28] These comments are also applicable to proposed Sections 1777.23(c)(1) and (c)(3).

[29] 12 U.S.C.A. §4618(c)(3).

[30] This line of reasoning also applies to proposed Section 1777.25(b), and Fannie Mae requests that comparable revisions be made to that section.

Section 1777.21(b)(1) requires a company to provide notice to OFHEO "of any material development that may reasonably be expected to cause the enterprise's core or total capital to fall to a point that could result in assignment of the enterprise to a lower capital classification." Fannie Mae strongly objects to this requirement on the grounds that it is too vague and completely unnecessary. The consequences of failing to provide notice of such material adverse developments -- the issuance of a temporary or final cease and desist order or civil money penalties -- are simply too great for the triggering event not to be stated clearly in the regulation. This provision suffers from the fact that such "material development" may be clear only in retrospect. The comprehensive and continuous on-site examination of Fannie Mae means that there is a continuous flow of relevant information between Fannie Mae and its examiners. Events that "could result in assignment of the enterprise to a lower capital classification" will not escape the attention of OFHEO's highly trained and experienced professional examiners. Accordingly, Fannie Mae asks that OFHEO withdraw this provision or at a minimum revise it to state explicitly those events that would trigger such a notice.

Section 1777.22, Limitations on Capital Distributions. Proposed Section 1777.22 states that a determination by OFHEO to grant capital distributions in certain circumstances is "in its discretion." Fannie Mae notes that this language is not included in Section 1366(a)(2)(B) of the 1992 Act[31] and thus it should be removed from the proposed rule.

Section 1777.23, Capital Restoration Plan. Fannie Mae has numerous concerns regarding the capital restoration plan provisions of the proposed rule.

First, Fannie Mae disagrees with the proposal's imposition of only a ten-day period after notice of applicable capital classification for a company to provide OFHEO with a capital restoration plan in proposed Section 1777.23(a)(1). Although it appears that a literal reading of Section 1369C of the 1992 Act[32] would permit OFHEO to choose such an unreasonably short period of time for a company to prepare a capital restoration plan, Fannie Mae cannot understand why OFHEO would choose to do so. First, such limited time perversely incents a company to file an inadequate plan because, by statute, it subsequently must be given an additional 30 days to submit an alternative plan if the initial plan is not approved. Moreover, all of the banking regulators provide their regulated institutions the full 45 days to file a plan. In such a critical time, it is in everyone's best interest to give a company sufficient and reasonable time to prepare an adequate capital restoration plan.

Second, Fannie Mae also disagrees with the proposal's assertion in proposed Section 1777.23(a)(2) that OFHEO may require a company operating under a capital restoration plan approved by OFHEO to submit a new capital restoration plan "within the deadline specified in such

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[31] 12 U.S.C.A. §4616(a)(2)(B).

[32] 12 U.S.C.A. §4622.

notice" of obligation to file a new plan. Any action by OFHEO to subsequently disapprove a capital restoration plan that had been previously removed is tantamount to a disapproval of an initial plan. If OFHEO disapproves an initial capital restoration plan, a company must be given 30 days to submit a new plan.[33] Thus, by statute, OFHEO does not have discretion to determine how long a company already operating under a capital plan has to submit a new capital plan, and OFHEO must provide a company at least 30 days for such submission.

Third, proposed Section 1777.23(b)(1)(vi) of the proposal references "action, inaction, or conditions" as a substitute for "conduct." Fannie Mae has suggested above that "conduct" does not need to be defined and has recommended replacing that definition with the actual word. Fannie Mae repeats that suggestion here.

Fourth, Fannie Mae disagrees with the assertion in proposed Section 1777.23(c)(1) that OFHEO need not provide additional notice to a company that fails to submit a capital restoration plan of OFHEO's reclassification of that company. OFHEO's authority to reclassify a company under these circumstances is discretionary, and all discretionary action is subject to prior notice under Section 1368(a) and (b).[34] For the same reasons, Fannie Mae also disagrees with the assertion that OFHEO is not required to provide notice of subsequent reclassification under proposed Sections 1777.23(c)(3) and (h)(1)(iii).

Fifth, Fannie Mae objects strongly to the proposal's assertion in proposed Section 1777.23(d) that OFHEO may issue an "order" approving or disapproving of a capital restoration plan and to the assertion in proposed Section 1777.23(h)(2) that "a capital plan that has received an approval order from OFHEO under this section constitutes an order under the 1992 Act." Section 1369C(c) of the 1992 Act[35] provides that OFHEO shall "provide written notice" of any approval or disapproval of a capital restoration plan. There is no statutory authority for the proposed regulation permitting OFHEO to provide an "order to the enterprise approving or disapproving the plan."

The distinction between a notice and an order is paramount. Under the enforcement provisions of the 1992 Act, OFHEO cannot issue a final cease and desist order, temporary cease and desist order, or civil money penalty against a company or its officer or director unless there is a violation of an "order, rule or regulation;"[36] a violation of a "notice" is insufficient grounds for administrative enforcement action. OFHEO cannot provide itself with authority that Congress did

[33] 12 U.S.C.A. §4622(d).

[34] 12 U.S.C.A. §4618(a) and (b).

[35] 12 U.S.C.A. §4622(c).

[36] *See* 12 U.S.C.A. §§4631(a)(3)(A), (b)(2), 4632, and 4636(a).

not give to it. Accordingly, Fannie Mae asks that all references in the proposed regulation to an "order" approving or disapproving of a capital restoration plan should be stricken and replaced with "notice."

Sixth, proposed Section 1777.23(h)(1)(i) fails to follow the text of the statute, and Fannie Mae asks that it be revised to do so. This section of the proposal provides that "[i]f OFHEO determines, in its discretion, than an Enterprise has failed to make efforts reasonably necessary to comply with the capital restoration plan and fulfill the schedule under the plan, OFHEO may reclassify the Enterprise." Section 1365(b) of the 1992 Act[37] provides that such discretionary reclassification may occur when "the Director determines that the enterprise has failed to make, *in good faith*, *reasonable efforts* to comply with the capital restoration plan and fulfill the schedule for the plan approved by the Director." (emphasis added). The statute requires that the Director base his determination, in part, on the good faith of the company.

Fannie Mae's seventh and final concern is that proposed Section 1777.23(g)(2) gives OFHEO nearly unlimited discretion in determining whether the obligations under a capital restoration plan should be terminated. Although the proposed regulation permits a company to make a written request for termination of its obligations, it leaves the decision whether to grant the request to the unlimited discretion of OFHEO. Fannie Mae believes that leaving such significant decisions to the unlimited discretion of the supervisory agency is fundamentally unfair. A capital restoration plan should be presumptively terminated after a certification by the company that the measures required have been fulfilled. In order to overcome the presumptive termination, OFHEO would be required to make specific, written findings of the circumstances justifying non-termination of the capital restoration plan. Any such findings should be appealable through an independent intra-agency process, as recommended below.

Section 1777.28, Appointment of Conservator. In a few places in this proposed section, the proposed text does not track the statute, and Fannie Mae suggests that it be revised to do so.

In proposed Section 1777.28(b)(2), because certain text included in Section 1367(a)(2) of the 1992 Act[38] is omitted, it is not clear that the written finding that the Director is making is that a conservator does not need to be appointed. Thus, Fannie Mae suggests that this section be revised to track the statute as follows:

> (2) Exception. Notwithstanding paragraph (b)(1) of this section, the Director of OFHEO may determine not to appoint a conservator for an enterprise classified as

[37] 12 U.S.C.A. §4615(b)(2).

[38] 12 U.S.C.A. §4617(a)(2).

> critically undercapitalized, but only pursuant to a written finding by the Director, with the written concurrence of the Secretary of the Treasury, that –
> (i) the appointment of a conservator would have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market; and
> (ii) the public interest would be better served by taking some other enforcement action authorized under Subtitle B of 1992 Act (12 U.S.C. 4611 through 4623) or under this Part.

Additional Considerations: Internal Appeals Process

One of the strengths of the supervisory regime that currently applies to Fannie Mae and Freddie Mac is its relative "flatness." Unlike the bank regulatory agencies, which are responsible for supervising many more institutions throughout the United States, OFHEO supervises only two institutions, both with headquarters in the Washington, D.C. area. As a result, OFHEO has no need for regional offices and other layers of administration that are found in the banking agencies.

One drawback of this relatively simple supervisory structure, however, is that it does not as readily lend itself to the checks and balances that exist when supervisory actions are subject to multiple layers of review. The proposed PCA regulation underscores this drawback: it contemplates a number of supervisory actions that OFHEO might take that could have seriously adverse consequences for a company, without providing for review of such actions as a general matter. At the same time, no intra-agency mechanism is contemplated for appealing such a determination other than the responses that a company is permitted to make to a notice of capital classification or reclassification or to a notice of intent to issue an order under proposed Sections 1777.21(a)(2) and 1777.25, respectively.[39]

Regardless of the final shape that the PCA regulation takes, Fannie Mae believes that the supervisory process as well as fundamental fairness would be well served by creating an internal appeals process similar to that mandated for the banking agencies by the Riegle Community Development and Regulatory Improvement Act of 1994.[40]

For example, the FDIC guidelines for appealing adverse supervisory determinations provide that material supervisory determinations (with certain notable exceptions, such as the appointment of a conservator or receiver) that are not otherwise subject to appellate review may be appealed by the affected institution to a committee of senior officers of the agency who do not report to the

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[39] *See* proposed Section 1777.27.

[40] Pub.L. 103-325, §309, 12 U.S.C.A. §4806.

officer or officers who made the adverse determination.[41] Similarly, OFHEO's regulation should provide a mechanism for a company that disagrees with an adverse determination under the PCA regulation to appeal the determination to a committee of senior OFHEO officers who do not report to the officers responsible for the adverse determination. The appeals process should be available both for supervisory responses and actions listed in proposed Sections 1777.11 and 1777.12 in Subpart A, and for adverse capital reclassifications under proposed Section 1777.20 in Subpart B. OFHEO should also provide for the establishment of an agency ombudsman, with the responsibility for ensuring that the companies are treated fairly in the supervisory process.

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For the reasons discussed above, Fannie Mae urges OFHEO to withdraw Subpart A and adopt Fannie Mae's suggested modifications to the preservation of authority and definitions sections and Subpart B of the proposal. If OFHEO decides to retain the prompt supervisory response regime of Subpart A, however, Fannie Mae strongly urges that OFHEO's staff responsible for understanding Fannie Mae's business meet with Fannie Mae business personnel so that DPSRs meaningful to how Fannie Mae's business operates may be devised.

We appreciate your consideration of our views.

Sincerely,

/s/

Ann M. Kappler

cc: Hon. Armando Falcon

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[41] *See* FIL-28-95, April 4, 1995.

Exhibit 1: The Nationwide Maximum Quarterly Foreclosure Average since 1979 has been Lower than that of any Census Division**

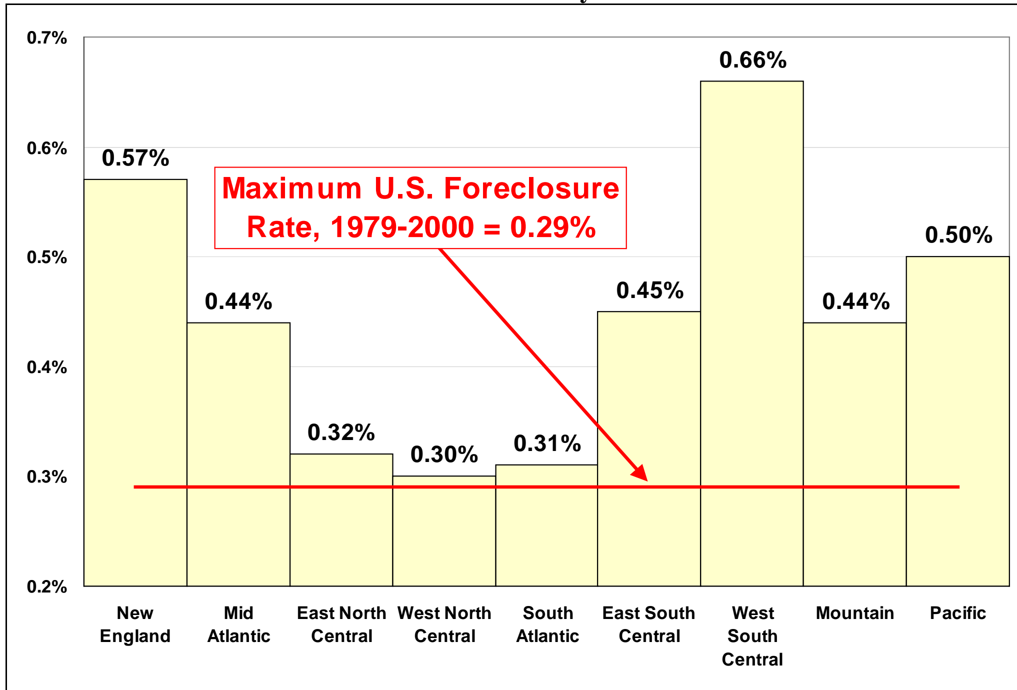


Exhibit 2: Foreclosure Rates for 1-4 Family Loans—U.S. vs. New England Census Division**

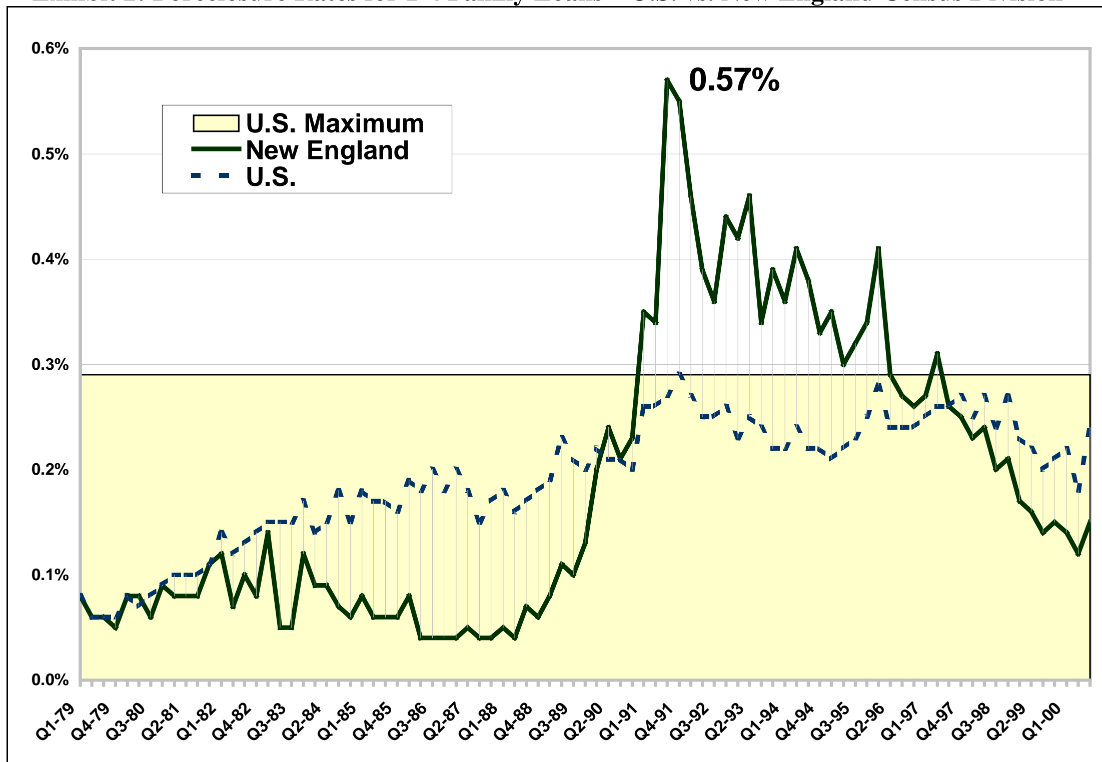
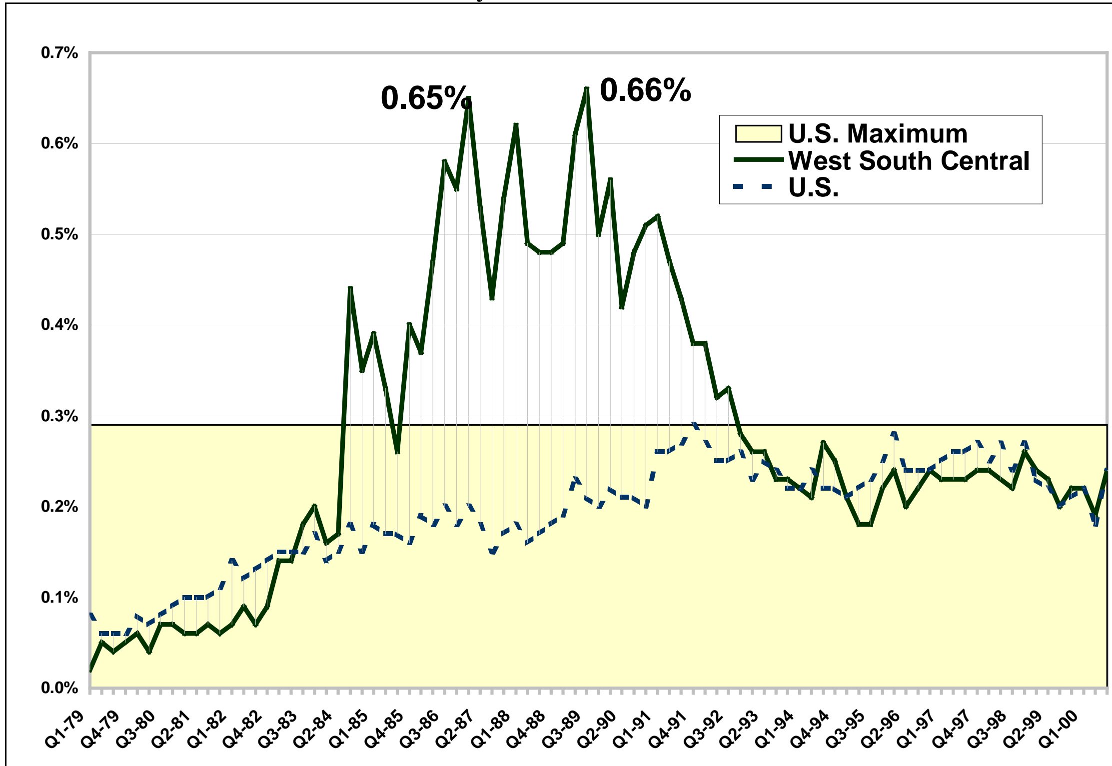


Exhibit 3: Foreclosure Rates for 1-4 Family Loans —U.S. vs. West South Central Census Division**



**Source: The National Delinquency Survey, Mortgage Bankers Association of America.