Federal Register

Wednesday,

December 5, 2007

Part III

Department of Housing and Urban Development

Office of Federal Housing Enterprise Oversight

12 CFR Part 1750

Risk-Based Capital Regulation—Loss Severity Amendments; Proposed Rule

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of Federal Housing Enterprise Oversight

12 CFR Part 1750

RIN 2550–AA38

Risk-Based Capital Regulation—Loss Severity Amendments

AGENCY: Office of Federal Housing Enterprise Oversight, HUD.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Office of Federal Housing Oversight (OFHEO) is amending Appendix A to Subpart B of 12 CFR part 1750 Risk-Based Capital (Risk-Based Capital Regulation). The amendments are intended to enhance the accuracy and transparency of the calculation of the risk-based capital requirement for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively the Enterprises). OFHEO proposes to amend further the Risk-Based Capital Regulation to change the loss severity equations that understate losses on defaulted single-family conventional and government guaranteed loans. OFHEO also proposes to amend the treatment of Federal Housing Administration (FHA) insurance in the Risk-Based Capital Regulation in order to conform the treatment to current law.

DATES: Comments regarding this Notice of Proposed Rulemaking must be received in writing on or before March 4, 2008. For additional information, see **SUPPLEMENTARY INFORMATION.**

ADDRESSES: You may submit your comments on the proposed rulemaking, identified by ''RIN 2550–AA38,'' by any of the following methods:

- *U.S. Mail, United Parcel Post, or other Mail Service:* The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/ RIN 2550–AA38, Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- *Hand Delivery/Courier:* The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/ RIN 2550–AA38, Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The package should be logged at the Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.
- *E-mail:* Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at *RegComments@OFHEO.gov*. Please include ''RIN 2550–AA38'' in the subject line of the message.

FOR FURTHER INFORMATION CONTACT: David A. Felt, Deputy General Counsel, telephone (202) 414–3750, or Jamie Schwing, Associate General Counsel, telephone (202) 414–3787 (not toll free numbers), Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Deaf is (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Comments

OFHEO invites comment on all aspects of the proposed amendments to the Risk-Based Capital Regulation, and will take all relevant comments into consideration before issuing the final regulation. OFHEO requests that comments submitted in hard copy also be accompanied by the electronic version in Microsoft® Word or in a portable document format (PDF) on 3.5″ disk or CD–ROM.

Copies of all comments will be posted on the OFHEO Internet Web site at *http://www.OFHEO.gov*. In addition, copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m. at the Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. To make an appointment to inspect comments, please call the Office of General Counsel at (202) 414–3751.

II. Background

Title XIII of the Housing and Community Development Act of 1992, Pub. L. 102–550, titled the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (the Act) (12 U.S.C. 4501 *et seq.*) established OFHEO as an independent office within the Department of Housing and Urban Development to ensure that the Enterprises are adequately capitalized, operate safely and soundly, and comply with applicable laws, rules and regulations. The Act provides that the Director of OFHEO (the Director) is authorized to make such determinations and take such actions as the Director determines necessary with respect to the issuance of regulations regarding, among other things, the required capital levels for the enterprises.[1] The Act further provides that the Director shall issue regulations establishing the risk-based capital test and that the Risk-Based Capital Regulation, subject to certain confidentiality provisions, shall be sufficiently specific to permit an individual other than the Director to apply the risk-based capital test in the same manner as the Director.[2]

Pursuant to the Act, OFHEO published a final regulation setting forth a risk-based capital test which forms the basis for determining the risk-based capital requirement for each Enterprise.[3] The Risk-Based Capital Regulation has been amended to incorporate corrective and technical amendments that enhance the accuracy and transparency of the calculation of the risk-based capital requirement.[4]

Consistent with the Act, OFHEO proposes to amend further the Risk-Based Capital Regulation to change certain loss severity equations that understate losses on defaulted single-family conventional and government guaranteed loans. OFHEO also proposes to amend the treatment of FHA insurance in the Risk-Based Capital Regulation in order to conform the treatment to current law.

As currently specified, certain loss severity equations allow the Enterprises to record negative losses (i.e., profits) on foreclosed mortgages during the calculation of the risk-based capital requirement. Unaltered, the current loss severity equations overestimate Enterprise recoveries for defaulted government-guaranteed and low loan-to-value (LTV) loans. The results generated by the current loss severity equations are not consistent with the goals of the Risk-Based Capital Regulation and result in significant reductions in the risk-based capital requirements of the Enterprises. The amendments to the relevant equations are set forth below.

A. Loss Severity

Loss Severity is the net cost to an Enterprise of a mortgage loan default. The Risk-Based Capital Regulation uses the costs associated with different events following the default of a mortgage to determine the total loss or cost to an Enterprise. Loss severity rates are computed as of the date of default and are expressed as a percentage of the unpaid principal balance of a defaulting loan. In general, losses on a loan include the unpaid principal balance of the loan, lost interest, foreclosure costs, and expenses related to real-estate-owned. *See* paragraph 3.6.3.6.1, *Calculation of*

[1] 12 U.S.C. 4513(a), (b)(1), (b)(3).

[2] 12 U.S.C. 1361(e)(1), (e)(3).

[3] Risk-Based Capital, 66 FR 44730 (September 13, 2001), 12 CFR part 1750.

[4] Risk-Based Capital, 66 FR 44730 (September 13, 2001), 12 CFR part 1750, *as amended*, 67 FR 11850 (March 15, 2002), 67 FR 19321 (April 19, 2002), 67 FR 66533 (November 1, 2002), 68 FR 7309 (February 13, 2003), 71 FR 75085 (December 14, 2006).

Single Family and Multifamily Mortgage Losses Overview.[5] Losses may be reduced by mortgage insurance proceeds, pool-level credit enhancement proceeds, and recovery proceeds from the sale of the foreclosed property, as set forth at paragraph 3.6.1[h], subtitled *Specification of Mortgage Default and Loss* and paragraph 3.6.3.6.2.1, subtitled, *Single Family Gross Loss Severity Overview.*[6]

Since the adoption of the Risk-Based Capital Regulation, OFHEO has gained extensive operating experience with the administration of the rule. A review of the loss severity equations as currently specified indicates that changes are required to correct deficiencies in the equations related to the calculation of loss severity rates for single-family conventional and FHA mortgages and single-family Department of Veterans Affairs (VA) mortgages. In addition, the current treatment of FHA insurance associated with single-family loans with an LTV below 78% is inconsistent with current law and should be corrected as detailed below.

i. Conventional Single-Family Loan Groups

The current treatment for calculating loss severity rates for conventional single-family loan groups is set forth in the Risk-Based Capital Regulation, paragraph 3.6.3.6.5.1, as a subtopic under the general heading of *Single Family and Multifamily Net Loss Severity Procedures.*[7] The following equation shows the loss severity model for conventional and FHA mortgages in the RBC regulation:

$$LS_m^{SF} = \frac{1}{\left(1+\frac{DR_m}{2}\right)^{\frac{MQ}{6}}} + \frac{\left(\frac{MQ}{12}\times PTR_m\right)+F-MI_m}{\left(1+\frac{DR_m}{2}\right)^{\frac{MF}{6}}} + \frac{R-RP_m-ALCE_m}{\left(1+\frac{DR_m}{2}\right)^{\frac{MF+MR}{6}}}$$

Where:

LS_m^{SF} = Net loss severity for conventional and FHA single-family loans in month m
MI_m = Mortgage insurance proceeds in month m
$ALCE_m$ = Aggregate limit credit enhancement in month m
MR = Months to recovery
F = Foreclosure costs
MQ = Months delinquent
PTR_m = Pass through rate for payments in month m
R = REO expenses
$RP_m = (0.61/LTV_q)$ = Recovery proceeds in month m. The 0.61 is the recovery rate on defaulted loans in the benchmark loss experience as a percentage of the predicted house price using the HPI.
LTV_q = Loan to value ratio in month q (current LTV)
DR_m = Discount rate in month m

This equation produces negative losses (profits) for low LTV loans. This result, profits on defaults, is inconsistent with the stress environment envisioned by the statute. Specifically, the problem arises with the term used to estimate the value of recovery proceeds as a percentage of the loan amount outstanding, RP_m, which is set equal to $0.61/LTV_q$. This term yields a value greater than one when LTV_q falls below 61%, resulting in the projected recovery proceeds exceeding the defaulted UPB. If the projected recovery proceeds exceed the other costs as well as the defaulted UPB, the result is a negative loss (profit).

More specifically, RP_m is problematic because it relies on LTV_q, which represents the estimated current LTV of a loan, assuming the mortgaged property has appreciated in value at the mean rate for the Census Division. Because LTV_q incorporates mean rather than actual house price appreciation, using LTV_q to measure how the loan amount compares to the property value can be misleading. Not all property values change at the mean rate; some perform less well. Loans with low LTV_q values that default generally are collateralized by properties whose values appreciated much less than properties securing other loans originated at the same time, and in the same Census Division. Such loans would normally only default rather than prepay if the defaulting borrowers cannot fully pay off the loan by selling the house because their actual current LTV ratio is higher than LTV_q. Thus the recovery rate generally is less than 61% on these defaulted loans.

The problem with the estimate of recovery proceeds has become acute, because the volume of loans in the Enterprises' portfolios with low LTV_q has increased sharply in recent years due to rapidly rising house prices. While only a very small percentage of loans with low values of LTV_q default in the RBC model, there are now so many loans with low LTV_q values that the effects are pronounced. When this model specification was selected, this problem was relatively small, as there were few defaulting loans generating gains. Alternative specifications that avoided this issue added considerable complexity to the model and had other problems.

Profiting on defaults also is not consistent with the credit stress environment envisioned in the Risk-Based Capital Regulation. Despite having a low LTV, a homeowner may face unemployment and an illiquid housing market in the RBC stress environment. Upon foreclosure, the Enterprise would face the challenge of selling the property in the same illiquid market, making the prospect of a profit highly unlikely. Substantial profits on defaulted loans would be unlikely in any event because the law in a number of states requires any ''extra'' proceeds from a foreclosure to revert to the mortgagee, not the holder of the mortgage.

OFHEO proposes to correct the loss severity equation for conventional and FHA mortgages such that the results of the equation are constrained to be non-negative. This change will eliminate the possibility of the Enterprises profiting on defaulted mortgages in the stress test model. The change addresses the weakness in the recovery equation and produces results that are more consistent with the credit stress environment envisioned in the RBC Regulation.

As part of its analysis, OFHEO considered two alternatives. One alternative would have restricted recovery proceeds to 120% of the outstanding loan amount.[8] Another alternative considered would have required the loss severity equation to be non-negative, except that MI and aggregate level credit enhancements payments would be received in full. These alternatives were not proposed

[5] 12 CFR part 1750 (2006), Subpart B, Appendix A, ¶ 3.6.3.6.1[c].

[6] Id. ¶ 3.6.1[h] and ¶ 3.6.3.6.2.1.

[7] Id. ¶ 3.6.3.6.5.1[a].

[8] The 120% figure reflects the total costs observed on defaulted loans in the benchmark loss experience (the loan amount (100%), the foreclosure expenses (3.7%) and real estate-owned (REO) expenses (16.3%).

because they would produce gains on defaults for certain loans.

ii. Veterans Administration Mortgages

The current treatment for calculating loss severities for single-family VA-guaranteed mortgages is set forth in the Risk-Based Capital Regulation at paragraph 3.6.3.6.5.1 as a subtopic under the general heading of *Single Family and Multifamily Net Loss Severity Procedures*.[9] The current loss severity equation for VA loans utilizes the same equation for recovery proceeds as the conventional and FHA loss severity equation, and thus may also generate negative losses. In order to address this issue, OFHEO proposes an amendment to revise the loss severity equation for VA loans such that the results of the equation are constrained to be non-negative.

During the development of this proposed amendment, OFHEO considered removing the recovery proceeds term from the VA loss severity equation in order to reduce the negative losses. However, this alternative does not accurately reflect the VA guarantee program, which may allow both recovery proceeds and the VA guarantee to be used to offset losses.

iii. Federal Housing Administration Insurance

The current treatment for consideration of FHA insurance in the calculation of loss severities is set forth in the Risk-Based Capital Regulation. See paragraph 3.6.3.6.4.3, as a subtopic under the general heading *Mortgage Credit Enhancement Procedures*.[10] The current equation cancels mortgage insurance for all loans when the LTV falls below 78%. Although this treatment is appropriate for loans with private mortgage insurance, FHA insurance remains in force irrespective of the LTV of a mortgage. OFHEO proposes not to cancel FHA insurance by amending the current equation.

B. Capital Impact of Proposed Amendments

The following table shows the estimated capital impact of all of the proposed amendments at September 30 and December 31, 2006.

TABLE 1.—ESTIMATED CAPITAL IMPACT OF PROPOSED AMENDMENTS

[Billions of dollars]

	Quarter	Interest rate scenario	RBC requirement		
			Current regulation	Current regulation with proposed amendments	Change *
Fannie Mae	2006 3Q	Up-Rate	$22.5	$32.0	$9.5
		Down-Rate	16.4	25.1	8.6
	2006 4Q	Up-Rate	26.9	36.6	9.8
		Down-Rate	9.1	16.6	7.5
Freddie Mac	2006 3Q	Up-Rate	14.9	19.4	4.5
		Down-Rate	13.8	18.2	4.4
	2006 4Q	Up-Rate	15.3	20.7	5.4
		Down-Rate	12.9	17.5	4.5

* Figures may not sum precisely due to rounding.

The proposed amendments substantially increase the RBC Requirement in both the up and down interest rate scenarios for both Enterprises for the two quarters analyzed. However, if the proposed amendments had been in effect during the analyzed periods, total capital would have exceeded the RBC Requirement and the capital classifications of the Enterprises would not have changed.

Regulatory Impacts

Executive Order 12866, Regulatory Planning and Review

The proposed amendments to the Risk-Based Capital Regulation incorporate corrections to the loss severity equations used to calculate the risk-based capital requirements of the Enterprises. The proposed amendments to the Risk-Based Capital Regulation are not classified as an economically significant rule under Executive Order 12866 because they do not result in an annual effect on the economy of $100 million or more or a major increase in costs or prices for consumers, individual industries, Federal, state or local government agencies, or geographic regions; or have any significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in foreign or domestic markets. Accordingly, no regulatory impact assessment is required. However, as a regulatory action with significant policy implications, the proposed amendments were submitted to the Office of Management and Budget for review under applicable provisions of Executive Order 12866.

Executive Order 13132, Federalism

Executive Order 13132 requires that Executive departments and agencies identify regulatory actions that have significant federalism implications. A regulation has federalism implications if it has substantial direct effects on the states, on the relationship or distribution of power between the Federal Government and the states, or on the distribution of power and responsibilities among various levels of government. The Enterprises are federally chartered entities supervised by OFHEO. The proposed amendments to the Risk-Based Capital Regulation address matters with which the Enterprises must comply for Federal regulatory purposes. The proposed amendments to the Risk-Based Capital Regulation address matters regarding the risk-based capital calculation for the Enterprises and therefore does not affect in any manner the powers and authorities of any state with respect to the Enterprises or alter the distribution of power and responsibilities between Federal and state levels of government. Therefore, OFHEO has determined that the proposed amendments to the Risk-

[9] 12 CFR part 1750 (2006), Subpart B, Appendix A, ¶ 3.6.3.6.5.1[b]2.

[10] Id. ¶ 3.6.3.6.4.3[a]1.

Based Capital Regulation have no federalism implications that warrant preparation of a Federalism Assessment in accordance with Executive Order 13132.

Paperwork Reduction Act

The proposed amendments do not contain any information collection requirement that requires the approval of OMB under the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation does not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b). OFHEO has considered the impact of the proposed amendments to the Risk-Based Capital Regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the proposed amendments to the Risk-Based Capital Regulation are not likely to have a significant economic impact on a substantial number of small business entities because the regulation is applicable only to the Enterprises, which are not small entities for purposes of the Regulatory Flexibility Act.

List of Subjects in 12 CFR Part 1750

Capital classification, Mortgages, Risk-based capital.

Accordingly, for the reasons stated in the preamble, OFHEO is amending 12 CFR part 1750 as follows:

PART 1750—CAPITAL

1. The authority citation for part 1750 continues to read as follows:

Authority: 12 U.S.C. 4513, 4514, 4611, 4612, 4614, 4618.

2. Amend Appendix A to subpart B of part 1750 as follows:

a. In paragraph 3.6.3.6.4.3[a]1, revise the explanation following the equation;

b. In paragraph 3.6.3.6.5.1[a] revise equation;

c. In paragraph 3.6.3.6.5.1[b]2 revise equation.

Appendix A to Subpart B of Part 1750—Risk-Based Capital Text Methodology and Specifications

* * * * *

3.6.3.6.4.3 * * *

[a] * * *

1. * * *

Where:

m′ = m, except for counterparties rated below BBB, where m′ = 120

$$MIExp_m^{LG} = 1 \text{ if } \left(\left(LTV_{ORIG} \times \frac{UPB_m^{LG}}{UPB_{ORIG}^{LG}} \right) < 0.78 \right) \text{ and conventional loan}$$

$$MIExp_m^{LG} = 0 \text{ otherwise}$$

0.78 (78%) = the LTV at which MI is cancelled if payments are current

* * * * *

3.6.3.6.5.1 * * *

[a] * * *

$$LS_m^{SF} = MAX \left[\left(\frac{1}{\left(1 + \frac{DR_m}{2}\right)^{\frac{MQ}{6}}} + \frac{\left(\frac{MQ}{12} \times PTR_m\right) + F - MI_m}{\left(1 + \frac{DR_m}{2}\right)^{\frac{MF}{6}}} + \frac{R - RP_m - ALCE_m}{\left(1 + \frac{DR_m}{2}\right)^{\frac{MF + MR}{6}}} \right), 0 \right]$$

[b] * * *

2. * * *

$$LS_m^{VA} = \max \left[\frac{1 + F + \left(\frac{MQ}{12} \times PTR_m\right) + \left(R - RP_m\right) - 0.30}{\left(1 + \frac{DR_m}{2}\right)^{\frac{MF}{6}}}, 0 \right]$$

* * * * *

Dated: October 11, 2007.

James B. Lockhart III,

Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. 07–5101 Filed 12–4–07; 8:45 am]

BILLING CODE 4220–01–P