1919 Pennsylvania Avenue, NW
Washington, DC 20006-3438
www.mbaa.org

January 17, 2002

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

Dear Mr. Pollard:

The Mortgage Bankers Association of America ("MBA") is pleased to have the opportunity to comment on the proposed changes to the risk-based capital rule for the Government Sponsored Enterprises (the GSEs). OFHEO is to be commended for recognizing that such a complicated rule will have unexpected problems that will need to be addressed on an ongoing basis. In particular, we want to express our appreciation for the way that OFHEO moved to promptly correct problems that quickly became apparent with the multifamily portion of the September 13th final rule.

The MBA believes that the proposed rule contains a number of important improvements over the final capital regulation, improvements that will more closely align capital requirements with the risk of specific programs. Our comments, therefore, will concentrate on areas where we believe the improvements did not go far enough.

Counterparty risk and haircuts

The proposed regulation is a significant improvement over the final rule in that it reduces the haircut levels for AAA through BBB rated counterparties and instruments, and extends the phase-in period from five to ten years. While we agree with the phase-in period, we believe the levels of the haircuts are still too high for two reasons. First, we believe the benchmark period selected for the default levels is not consistent with the Federal Housing Enterprise Safety and Soundness Act of 1992 (the Act) that is the statutory basis for the risk-based capital rule. Second, we believe the severity rates used are inappropriate for many of the counterparties having obligations to the GSEs.

The proposed rule specifies that the counterparty default rates are based on the default rates of bonds issued in 1929, 1930 and 1931. These, according to OFHEO, were the worst annual cohorts of U.S. investment-grade issues since 1920. However, the Act

does not direct OFHEO to base capital requirements on a Great Depression standard. To the contrary, the Act states that:

> *"Losses or gains on other activities, including interest rate and foreign exchange hedging activities, shall be determined by the Director, on the basis of available information, to be consistent with the stress period." (12 USC Sec. 4611(a)(4)*

and

> *"Characteristics of the stress period other than those specifically set forth in subsection (a) of this section, such as prepayment experience and dividend policies, will be those determined by the Director, on the basis of available information, to be most consistent with the stress period." (12 USC Sec. 4611(b)(2)*

The legislation specifies that the stress period is to be a national stress event characterized by the worst regional experience, not the Great Depression. We believe that OFHEO should select bond default and severity rates consistent with the stress period it has selected.

An approach to determining the haircut levels that, in our opinion, would be consistent with the statute would be for OFHEO to determine macroeconomic measures that would characterize the stress period, such as declines in employment and bankruptcy. These macroeconomic measures would most likely lie somewhere between those of the past decade and those of the Great Depression. OFHEO could then set the counterparty default rates proportionately between the Depression experience and more recent experience. The result would not only be lower haircuts than those proposed by OFHEO but a much smaller difference between counterparties rated AAA and AA.

The second component of the haircuts assigned in the proposed rule is an average 70% severity rate. In addition to the arguments made above with regard to the default rates, OFHEO should recognize the differences that might exist between the companies that failed in the 1929-31 cohort and the types of firms that are counterparties to the two Enterprises today, with particular recognition of the residual cash flows that will accrue to the GSEs in the event of a failure of one of these counterparties.

Finally, the MBA believes there should be no difference in the haircut levels assigned to AAA and AA companies. We do not believe the historical evidence supporting the difference OFHEO has proposed is strong enough to justify the market disruptions that would likely result if the haircuts remained at the levels proposed. As a practical matter, the impact of this portion of the rule will be felt most heavily by the mortgage insurance (MI) industry and the borrowers and lenders who utilize MI. Simply put, we believe the Director should exercise his discretion in selecting appropriate historical information and guard against adversely affecting a competitive and successful MI industry. As the MBA has stated in our previous comment letters to OFHEO, if the risk-based capital rule creates a business incentive for the GSEs to favor doing business with the two AAA-rated MIs rather than the AAA-rated and AA-rated MIs, the result will be a concentration

of business that will be inimical to the interests of low- and moderate-income homebuyers. Therefore, the MBA recommends that OFHEO determine an historically appropriate haircut that is the same for AAA and AA-rated MI companies.

Haircut levels for unrated Delegated Underwriters and Servicers

The MBA very much appreciates the efforts OFHEO has made in showing a willingness to take into account factors that would permit a rating higher than BBB for unrated DUS lenders. However, the proposed rule appears to state that only fully funded reserve accounts pledged to the Enterprise will be considered in awarding a higher rating. We believe relying solely on fully funded reserve requirements as the basis for awarding higher ratings ignores several fundamental sources of collateral supporting the DUS guaranty.

The most important issue to recognize is that the reserve account is only one of the factors Fannie Mae uses in attempting to equalize its risk exposure across its DUS lenders. Fannie Mae also looks at capitalization and liquidity, as well as portfolio size, risk, diversification and historical performance in determining the appropriate level of funded reserve accounts. To select only the reserve account as a measure of safety and soundness would be a distorted measure of the actual relative risk of the DUS lenders. In addition, it should be noted that a number of lenders do not participate in the Fannie Mae DUS program because they do not wish to bear the costs imposed by the program, costs which are directly related to safety and soundness. Thus the DUS lenders have already self-selected into a very safe group of counterparties. OFHEO should be very careful, therefore, in attempting to ascertain differences in risk among this group of companies based solely on one measure of risk.

What other factors should OFHEO take into consideration? First, the major rating agencies certainly take into consideration a company's capital and other reserves in awarding a rating. OFHEO should likewise. Second, the continuing servicing fee stream on a defaulted DUS lender's remaining portfolio is a source of cash that is not taken into account in the current model. OFHEO should include the continuing cash flows from the DUS lender fee streams, either by including them explicitly in the model or by taking them into consideration along with the funded reserves in assigning haircut levels.

It is very important that OFHEO fully understand the nature of the DUS fee stream and why it differs from the servicing fees on the single-family side of the business. The income stream to the DUS lenders is approximately 38 bps and is made up of two parts: approximately 2 basis points for the actual cost of servicing; and the remainder as the risk premium portion for the DUS guaranty. All 38 bps are pledged to Fannie Mae and would automatically begin flowing to Fannie Mae in the event of the failure of a DUS lender. Unlike single family servicing, this fee is not subject to impairment due to prepayments. It is fully protected by the same yield maintenance provisions that the

proposed rule now takes into consideration in setting the prepayment rate to zero in the down-rate test for loans in yield maintenance. In addition, the actual costs of servicing would not significantly reduce the net proceeds from this fee. While on the single family side OFHEO assumes that the 25 basis point servicing fee would simply be transferred from one servicer to another in the event of default, with no change in the revenue to Fannie Mae, this is not the case with the DUS multifamily fee, where the servicing could be transferred risk-free to a replacement servicer and the net fee to Fannie Mae would increase. Even assuming that in a stress environment the cost of pure servicing would increase 50% to 3 basis points, that leaves a fee stream of 35 basis points net additional cash to Fannie Mae in the event of a DUS lender failure.

OFHEO cannot assume that this 35 basis point portion of the DUS fee would go to a replacement servicer unless OFHEO also assumes that the replacement servicer would assume the guaranty on the remaining portfolio. This is a highly dubious assumption in a stress environment, but it points out the choice OFHEO must make. If it is to be assumed that the full 35 basis point fee will transfer to a new servicer, and therefore will be excluded from the cash flows in the test, it must also be assumed then that there will be no haircuts because the replacement servicer will make any payments that would have been made by the original servicer. If OFHEO is not going to make this assumption, then it needs to account for these cash flows in modeling the returns to Fannie Mae in the event of a default by a DUS lender. If this is too large of a change to make in this round of the development of the model, then OFHEO should in some fashion recognize the capitalized value of these fee streams and add them to the fully funded reserves in determining haircut levels.

How should these DUS fee streams be valued? All DUS lenders value these servicing rights on their balance sheets at multiples of between 5 and 7, values affirmed by auditors at the major accounting firms. Using the midpoint of the valuations, a multiple of 6, the risk premium portion alone is equal to 210 bps of UPB. Note that this valuation does not depend on Fannie Mae being able to sell the DUS fee streams in the stress test. Rather, it merely represents the present value of the new cash flows that would automatically go to Fannie Mae. If it is assumed that 20% of the portfolio of a failed DUS lender has defaulted, a rate which appears to be more than twice the average multifamily default rate in the test, this leaves a remaining cash flow stream valued at 168 bps, much higher than the reserve levels referenced in the proposed regulation.

In summary, the DUS program has proven extremely successful in aligning the incentives of loan originators and investors through risk sharing and fee sharing. We are very concerned that reliance on fully funded reserves as the sole criterion in determining the haircuts for DUS lenders ignores the underlying economics of the program and could result in distorting the program by disadvantaging lenders who mitigate their risk through methods other than a fully funded reserve equal to 1% of unpaid balances. Therefore, we request that the rule be amended to allow a broader range of criteria to be used by the Director in assigning DUS haircut levels. In addition, we believe that the extensive requirements placed on all DUS lenders justifies an

across the board rating of AA until such time as a more exact model is developed that fully incorporates all of the cash flows in the DUS program.

Multifamily default and severity

The MBA believes the proposed rule represents a tremendous improvement over the current rule with respect to multifamily defaults and severity in the stress test. We congratulate OFHEO for making the changes needed to reflect more accurately the risk in this business and the relative risk of different types of mortgage products. However, we believe that additional changes would further enhance the model and our comments on the specific changes proposed follow.

Changes to the ARM flag

The MBA supports the proposed change to the ARM flag in the model. The proposed change removes the higher default variable applied to all ARMs and replaces it with a variable that applies only to ARMs originated under credit standards other than those currently used by the Enterprises. While the name of the variable is somewhat confusing, the effect is to strike a reasonable compromise between current underwriting standards and those that were in place years ago.

The one question we have is how the definition of this variable would be affected by any future changes in the underwriting standards of the agencies. For example, if as a result of ongoing experience, the standards of the agencies were to become tighter or looser, or simply emphasize different financial ratios, would the entire current ARM portfolios of the two companies be subject to this variable? We believe OFHEO should clarify this point in the final rule.

Underwater Debt Service Coverage Flag

The proposed rule changes the point at which the flag is turned on from a DCR less than 1.0 to a DCR less than .98. The MBA supports this change as an interim fix, but believes a more appropriate approach would be to model the underwater DCR as a continuous variable rather than a simple indicator variable. The reason is that a loan with a .88 DCR is much more likely to default than a loan with a .98 DCR, yet this proposed variable treats the default probability as being the same.

While a lack of updated DCRs in the very old data on which the model is based might preclude a statistically accurate coefficient, we feel confident that OFHEO can develop a reasonable approximation. While the proposed rule makes reference to the inability to develop a measure of diffusion for the multifamily model as exists for the single-family model, this level of complexity is of marginal value in the single-family model and the

diffusion can as easily be reflected in the baseline multifamily default rates, as is effectively done with the current model.

Finally, special mention should be made of the impact of this variable on ARMs. The combination of the way this variable is modeled and the decision OFHEO has made elsewhere in the rule on the shape of the yield curve will likely have the effect of sharply curtailing the multifamily ARM market.

Change to the starting vacancy rate

The proposed rule changes the starting vacancy rate from 6.23% to 10%. The MBA supports this technical change.

Changes to the prepayment rate in the down-rate scenario for loans in yield maintenance.

The proposed rule changes the prepayment rate for loans in yield maintenance periods from 2% to 0%. The MBA supports this change as a reasonable simplification of the complexities of modeling individual prepayment penalty contracts.

Changes in the calculation of severity.

The proposed rule increases the assumed gain on the sale of defaulted properties from 58.88% to 63%, reduces the time from default to foreclosure, reduces the net holding costs, and increases the time from acquisition to disposition. The MBA supports all of these changes as a way to reflect more reasonably the entire history of multifamily property disposition, while still imposing very stressful conditions.

Other items in multifamily model

In addition to the changes to the multifamily default model contained in the proposed rule, there are a few other areas of the multifamily model that the MBA believes need to be addressed.

Seasoning variable

The model in the current rule contains a seasoning variable that increases defaults as a loan ages. The coefficients on the age variable may be a result of looking at historical data where many original DCRs were not available, much less updated DCRs. In other words, the seasoning variable might be significant in a model estimated on historical data, but the seasoning variable is only picking up the effect of a lack of updated DCRs.

Therefore, it may be the case that seasoning is not significant for more recently originated loans with updated financial information. We urge OFHEO to take this into consideration in any future re-estimations of the model, and that it might be more appropriate to reflect only the seasoning that occurs within the 10 years of the stress test, not the age of the loan entering the test.

Low income housing

While no explicit reference is made in the proposed rule for loans for multifamily properties serving low-income tenants, the MBA supports the efforts of OFHEO to account separately for these properties in the data submitted by the agencies. In particular, properties with Section 8 rent subsidies should reflect lower expected vacancy rates in a stress event. More importantly, these projects should be viewed as carrying an implicit FHA guaranty due to the Section 8 contracts. For low income housing tax credit properties, the financial ratios should be adjusted to reflect the value of the tax credits and the tax recapture penalties should the property be allowed to default. We urge OFHEO to finalize its approach to characterizing these loans in the stress test.

Refunding rule

The proposed rule contains an alternative approach to specifying a refunding rule for the agencies in the stress test. The specified mix of long-term and short-term debt that the agencies would be expected to raise in the stress event is very important in determining the level of capital the agencies must hold for interest rate risk. Leaving aside the question of how much risk is inherent in the companies' portfolios due to their massive sizes, and the potential risk portfolios of this size might pose to the mortgage market and financial system, we question whether the proposed refunding rule introduces a volatility into the capital standard that has little to do with the risk of the two firms.

The proposed rule specifies that the companies maintain throughout the stress test the mix of long-term and short-term debt that exists at the beginning of the stress test. However, during periods when interest rates are rising or declining, the mixes of long-term and short-term debt are likely to be altered as the firms match the changing durations of their portfolios. Under the proposed rule, it is entirely possible that efforts of the agencies to reduce risk by temporarily changing their mixes of debt maturities could increase required capital. Our concern is that the capital requirements resulting from this refunding rule would cause the agencies to curtail their activities in the housing market at unpredictable times.

The difficulty of developing a refunding rule that matches the stress test conditions should be mitigated by the fact that OFHEO only needs to concern itself with two

companies and two rate scenarios. The justifications given for this proposed change, as well as the earlier versions of the funding rule, do not meet the high standards OFHEO set in developing the other sections of the rule, especially the single family default and prepayment sections. We suggest that OFHEO meet with appropriate outside portfolio risk management experts and devise one funding rule for the up-rate scenario and one for the down-rate scenario, and use its examination authority to ensure that the companies have sufficient expertise in-house to carry out such strategies.

In conclusion, the MBA very much supports the efforts of OFHEO to perfect the risk-based capital rule and appreciates the opportunity to comment on these proposed changes. The proposed rule is a significant step forward in achieving a risk-based capital standard that is fair and reasonable, provides stability for the overall market and minimizes exposure to the American taxpayer. The MBA stands ready to work with OFHEO on any policy or data issues as they arise.

Most sincerely,

Jonathan L. Kempner