Enrico Dallavecchia

Executive Vice President and Chief Risk Officer
Chief Risk Office

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 6804
202 752 0911 (fax)
enrico_dallavecchia@fanniemae.com

March 4, 2008

Alfred M. Pollard, Esq.
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street NW
Washington, DC 20052

Re: RIN 2550-AA38 (Risk Based Capital Regulation – Loss Severity Amendments)

Dear Mr. Pollard:

Fannie Mae respectfully submits these comments on the Office of Federal Housing Enterprise Oversight's ("OFHEO") proposal to amend Appendix A to Subpart B of 12 CFR Part 1750 concerning the risk-based capital ("RBC") standard. *See* 72 *Fed. Reg.* 68656 (December 5, 2007). According to the preamble of the proposal, the intent of the amendment is "to enhance the accuracy and transparency of the calculation of the risk-based capital requirement" for Fannie Mae and Freddie Mac. More specifically, the proposed amendments would change the loss severity equations for conventional and government guaranteed mortgages to preclude the occurrence of negative losses (i.e., gains) on foreclosed loans during the RBC stress test simulation. OFHEO states that this restriction will generate loss severities that are "more consistent with the credit stress environment envisioned in the RBC regulation."

Fannie Mae generally supports revising the loss severity calculations in the RBC regulation, especially the proposed change to retain FHA insurance coverage irrespective of the associated mortgage loan-to-value ("LTV"). We believe, however, that the current proposal fails both to properly recognize actual industry experience during times of credit stress and to properly incent Fannie Mae and Freddie Mac to engage in effective and innovative loss mitigation practices. By placing a uniform restriction on negative losses, we believe that the proposal weakens the intended relationship between capital and risk. We recommend OFHEO consider alternatives suggested below that would improve accuracy while still appropriately tying capital to risk.

Fannie Mae's Concerns

Proposal Contradicts Industry Experience

To support the proposed loss severity amendments, OFHEO asserts that prohibiting gains on foreclosed mortgages is consistent with the credit stress environment envisioned in the RBC rule. A blanket restriction on such gains contradicts Fannie Mae's experience. Our data shows that gains upon default not only occur with frequency, but also occur under stressful conditions defined by substantial home price declines.

We reviewed the Fannie Mae population of mortgage defaults that occurred between 1992 and 2006 where home price values had fallen 15 percent or more between origination and foreclosure. By way of contrast, average nationwide home prices decline by 13 percent in the RBC stress test. Within the selected population, two groups of loans show significant incidence of gains upon default - low LTV loans and loans with high levels of third-party mortgage insurance ("deeper MI"). Low LTV loans – those with original LTVs of 60 percent or less – generally carry no mortgage insurance yet showed gains upon default 20 percent of the time. Deeper MI loans – those with coverage in excess of the charter minimum – generate gains upon default in 6 percent of all cases despite having higher overall LTVs.

Using actual loan foreclosure data, the exhibit below shows how a deeper MI loan can generate a gain upon final disposition. Even in a rapidly falling home price environment, the larger MI claim payment is more than enough to offset the generally higher LTV.

Loan with Deeper MI
(Amounts rounded)

Product: 6.13% 30 year fixed rate
MI Coverage: 25%

Time	Event	Loan UPB	Home Price	LTV
Month 0	Origination	292,500	$325,000	90
Month 21	Foreclosure	289,300	$298,200	97
Month 26	REO Disposition		$258,700	

Net Loss Calculation:

Loan UPB at Default	$289,300	
Accrued Interest	$15,800	
Foreclosure and REO Costs	$14,600	
Total Costs		$319,700
MI Proceeds	$70,000	
Property Revenue	$258,700	
Total Proceeds		$328,700
NET LOSS (GAIN)		($9,000)

The significant incidence of negative loss severity on these two key loan groups underscores the range of factors that account for mortgagor defaults. Foreclosure gains on low LTV loans demonstrate that a sizeable proportion of homeowners actually do indeed default despite having positive equity in their homes. As the proposed amendment acknowledges, low LTV defaults may be precipitated by factors more directly tied to household liquidity issues, i.e., sudden cash flow problems due to unemployment, divorce, or poor financial management. Contrary to the proposal's assertion that illiquid markets make "the prospect of a profit highly unlikely", our experience shows that we are likely to generate an overall gain on low LTV loans in a down housing market about 20 percent of the time.

Consistent with more conventional logic, deeper MI loans primarily default because of negative home equity – mortgagors in this group start with little equity so that even modest home price declines result in underwater loan balances. Recognizing this risk,

Fannie Mae often requires greater mortgage insurance coverage to offset this heightened exposure. Consequently, even in cases where home prices have declined over 15 percent, 6 percent of mortgage foreclosures with deeper MI result have resulted in gains upon disposition.

Proposal Does Not Tie Capital to Risk

In essence, the proposed amendment represents more of a patch, rather than a fundamental re-engineering of the existing severity equations. In lieu of estimating new or improved relationships between input variables and losses, OFHEO has instead chosen to restrict the outcome of the existing severity equations to meet its expectations of stressful loss levels. This arbitrary restriction on the RBC stress test loss function not only contradicts empirical data, but also ignores important risk management tools designed to mitigate credit loss exposures. In short, the proposed amendments serve to exaggerate mortgage default losses, thereby failing to properly tie capital to risk.

In the case of low LTV loans, the proposed severity mechanism does not materially distinguish between defaults on a 50 percent LTV loan and an otherwise identical 40 percent LTV loan – both result in the same zero dollar loss. Adoption of the proposal implies that risk-based capital requirements will be largely insensitive to further declines in the riskiness of our low LTV mortgage book. The potential for measurement bias is especially real given that the proportion of lower LTV mortgages in Fannie Mae's portfolio has increased sharply in recent years.

As for deeper MI loans, the proposed non-negative cap on mortgage losses serves to impose an effective cap on credit enhancement (CE) benefits. The existence of extra primary coverage or back-end reinsurance that provides for reimbursement beyond gross mortgage loss will be ignored to the extent they would produce gains, even though such coverage is commonplace and represents good risk management practice that should be encouraged.

Indeed, CE contracts are now being written to yield a defined payment benefit upon default. The size of these payments is unrelated to the underlying gross loss. The potential for realizing a foreclosure gain is therefore quite likely. Because their simplified settlement does not require a negotiation over what loss components are claimable, defined benefit contracts may become increasingly common. The proposed amendments discourage not only greater reliance on defined benefit contracts, but also the pursuit of more innovative macro CE strategies where one set of loans might be nominally over insured in order to hedge credit risks on a wider set of loans.

Recommendations

Fannie Mae urges OFHEO to adopt an expansive, long-term view in revising the loss modeling regime. Rather than implement a blanket restriction on the end result, we recommend that OFHEO revisit all components that comprise the loss severity equations. In particular, we believe that the current rule's treatment of mortgage credit

enhancements fails to provide full credit for existing coverage, and is inflexible in reflecting more innovative structures.

More specifically, Fannie Mae recommends that OFHEO make the following modifications to the proposed amendments:

Revise Gross Loss Severity not Net Loss Severity

Gross loss severity is defined as the net foreclosure loss realized prior to receipt of credit enhancement or insurance proceeds, whereas net loss severity refers to the all-in loss after credit enhancements. OFHEO's proposed amendments attempt to address perceived issues with the calculation of gross loss severity; use of a fixed recovery proceeds assumption leads to realized gains on low LTV loans. However, rather than propose changes to the gross severity formula, OFHEO has chosen to unnecessarily constrain and thereby distort net severity outcomes. We recommend that OFHEO instead implement revisions to the calculation of gross severity rather than place uniform restrictions on net severity and the potential credit enhancement benefit. Such revisions should include review and parameterization of both foreclosure and property disposition costs since current expenditures are not reflective of those specified in existing rule.

Promote the Role of Credit Enhancement

Consistent with safety and soundness regulation, Fannie Mae believes the RBC rule should actively support and properly reflect the role of credit enhancement in limiting exposure to credit loss. As now implemented, the current rule already falls short on this measure.[1] Rather than providing for more complete recognition of existing and future credit enhancement structures, the proposed net loss severity limitation serves to further exclude recognition of existing credit enhancement benefits. To more properly recognize and promote sound risk mitigation practices, we suggest that OFHEO modify the proposed amendments in ways that might fully capture credit enhancement benefits.

We appreciate your consideration of our views.

Sincerely,

Enrico Dallavecchia
Executive Vice President and Chief Risk Officer

Cc: Steve Swad
Bill Senhauser

---

[1] The current rule provides for only one layer of primary mortgage insurance and two additional layers of credit enhancement. Positions in our existing book already can have more than the two layers recognized. Moreover, both the complexity and number of credit enhancements will likely continue to increase.